Mortality Design Considerations for Purchasers of COLI/BOLI Programs

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Series Abstract

All institutional purchasers and sponsors of life insurance should have enough knowledge about the mortality costs, benefits and risks associated with corporate owned and bank owned life insurance (COLI/BOLI) programs. The required knowledge includes an understanding of the differences between experience-rated mortality designs and non-experience rated designs, since failure to make an informed decision in this area can result in enormous, yet avoidable, exposures to excessive costs. It is also important to understand some of the legal, regulatory and accounting considerations that impact mortality risks. Finally, it is important to understand some of the common misconceptions about these programs that have been fostered by disinformation. This 3-part series of papers attempts to provide state of the art discussion to address these needs.

This first paper in the series, I. Effects of Experience Rating, addresses the consequences and advantages of experience rating and explains some of the factors that can lead to or limit excessive costs.

The second paper, II. Risk Transfer Considerations, addresses these considerations from a variety of perspectives. The discussion incorporates statements from taxing authorities, statements contained in statutory and GAAP accounting standards, notes on mathematical testing methods and the implications of catastrophic events. This paper includes an Appendix which offers a high level survey of significant court cases regarding risk transfer. The Appendix highlights four key cases that tangentially considered risk transfer in the course of examining whether the relevant policies had sufficient economic substance to make policy loan interest tax deductible.

The third paper in the series, III. Common COLI/BOLI Misconceptions, concludes with a discussion that debunks common misconceptions that have been used to criticize the purchase of COLI/BOLI programs. It discusses why employers have continued to purchase COLI/BOLI, and why the various criticisms of COLI/BOLI (both moral and financial) are misplaced.

Although many of the principles covered here apply to group term life purchases too, the series is directed to permanent life insurance products purchased on many lives.

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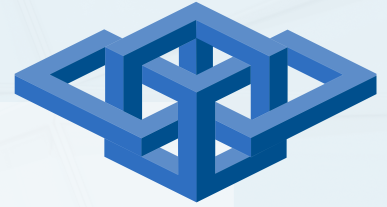
Effects of Experience Rating



Key goals of this Part I include:

- Provide an overview of the differences between experience-rated and non-experience rated product designs.
- Describe ways to ascertain exposures to excessive mortality-related costs and how to measure the potential extent of those exposures.
- Identify risks, downsides, and limitations of experience-rated designs, including the potential lack of sufficient risk shifting.
- Provide guidance regarding when experience-rated designs are more suitable than other designs (and vice versa).
- Enumerate some strategies for minimizing exposures to excessive mortality-related costs.

The authors observe that many owners and sponsors of permanent policies have needlessly been exposed to what might best be described as appallingly large exposures to excessive mortality costs. These phenomena beg a few questions. How did this happen? Who is responsible? We therefore also posit a few possible explanations for the prevalence of these occurrences.

Lastly, we endeavor to debunk some common misconceptions regarding why employers have and continue to purchase permanent life insurance.

Along the way, we will provide some notable historical background that we hope makes for a more interesting read.

Of course, mortality-related costs are but one of many types of costs and charges, both explicit and implicit, within permanent life insurance products. Therefore, this series should by no means be viewed as providing definitive advice regarding how to assure avoiding exposure to all excessive life insurance costs. That is a far more multifaced, complex exercise; one we've been engaged in for the past 30+ years.

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Pricing and Risk

We will begin the subject of pricing as viewed from an insurer's perspective with some fundamental concepts. When an insurer writes insurance coverage there is a risk that claims will be larger than premiums, so there could be losses. Therefore, for the insurance market to function, the insurer must have some capital that will be used to cover claims when there are losses. This capital is at risk. Before an investor will supply this capital, there must be an opportunity for profit, or return on capital. The amount of capital required and the desired rate of return will depend on, among other factors, the degree of risk.

In light of these principles, we will start our discussion of pricing with the premise that insurers will price their products so that the amount charged is sufficient to cover their expenses, including the costs of paying claims, and provide a reasonable return on their capital.

When we look at the simple example of term life insurance, the insurer must cover its operating expenses and life insurance claims costs. Within an insured population, most of the insureds will usually survive through the term, but some will die. The amount of claim payments is not knowable in advance. In our example, the insurer will base its price on the claims it expects to pay, plus its anticipated expenses, plus a margin for profit. The insurer will determine its expected claims using a mortality table that is based on experience that reflects the risks it is undertaking. On average, and assuming its table is accurate, the insurer knows that by using this approach it will lose on some insured populations and profit on others in any given time period. The insurer will try to set its pricing factors, including its profit margin, at a level where it can achieve its desired rate of return over the long term.

In the real world, pricing approaches are more complicated than this simple example. Many life insurance products have an insurance component and a savings or cash value component, so the insurer must consider the risks related to surrender or withdrawal of cash values in addition to the cost of paying expected claims, or pure insurance risk. Cash value life insurance products typically have mortality charges that are based on expected death claim payments, much like a term life insurance product. If they are offered in the insurer's separate account, it is typical for the investment performance of the separate account, less asset-based charges to be earned by the policy cash value. If they are offered in the insurer's general account, the insurer declares the interest to be credited to the policy cash value on a periodic basis. Different insurers may have a different view of the risks attendant to the different elements of the policy, and therefore may develop different pricing factors to cover the risks (and related profit margins). Additionally, insurers may look at external factors; for example, because insurance is offered in a competitive marketplace, the pricing offered by competitors must be considered because it will impact the product's sales results.

...the insurer must consider the risks related to surrender or withdrawal of cash values in addition to the cost of paying expected claims.

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Pricing and Risk (cont.)

For some products, the price is fully defined when coverage is issued. There are also instances where price is determined within defined limits at the issue date, but the insurer reserves the right to reprice within those limits. As one example, an insurer may define a current schedule of cost of insurance (COI) charges and reserve the right to change rates subject to a guaranteed maximum schedule or table of rates (this is a common approach for universal life and variable universal life insurance products). As another example, an insurer may declare the interest rate to be credited to policy cash value, but reserve the right to change the rate subject to a minimum guaranteed interest rate. There are also pricing factors for some products where the insurer is able to reprice with no explicit limits on repricing.

In the rest of this paper, we will base our discussion on the pricing elements of cash value life insurance policies that are related to charges for mortality costs. We will also assume that the charges for mortality costs are determined based purely on the costs of paying expected claims, together with related expenses and profit margins, without considering the relationship to other pricing factors or to external factors (such as competitive position) that may influence overall product pricing.

In defining their pricing for mortality costs, most insurers use a table of rates to cover mortality costs; the specific factor for each insured then depends on the entry in the table applicable to the insured's age and potentially other factors such as underwriting class or rate class, sex, and period since coverage was issued.

In the rest of this paper, we will base our discussion on the pricing elements of cash value life insurance policies that are related to charges for mortality costs.

When Experience Rating Applies

When experience rating applies, the insurer will recognize the experience of the insured population or group being evaluated. When this is done, the insurer typically has a basic table of charges that it applies to all groups, and performs a periodic re-pricing evaluation of the experience of each group. When the experience for a group is favorable to the insurer (when claims are lower than charges), a portion of the overcharges are refunded to the policy owner as experience credits, and/or the favorable experience results in lower future charges. When the claims for the group have exceeded charges, typically the future charge levels will be increased. (In general, the increase is limited based on a guaranteed maximum charge level.) Because there can be variation in experience from group to group, the insurer will generally charge a higher initial rate for experience-rated business than it would charge for business that consists of many groups that are not experience rated; this approach increases the probability that the charges for a group will be adequate to cover the claims for that group. The experience-rated customer may see larger charges at the point of sale, but due to experience credits it may experience lower net charges over the long term.

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When Experience Rating Applies (cont.)

Different insurers will have different techniques for evaluating experience-rated contracts and determining the future charges and credits. Under one technique, the insurer establishes the notional account for the policy owner. Credits to the account occur equal to the mortality charges levied against the contract. Deductions from the account are made at the time the claims are paid. Charges for target profit margins or to cover certain costs are also deducted from the account. Interest is credited to the account balance. From time to time, typically once per year, the insurer will evaluate the size of the balance in the account and its estimate of existing claim liability, and will decide whether to allow an experience credit of net overcharges, or to increase the basis for future charges because it has not been charging enough to cover claims costs, or to let the pricing stand without any adjustments. For these types of contracts, the insurer will generally also make a final determination after all coverage has been terminated and all claims have been paid. If there is a positive balance in the account it will result in final experience credits. If the account has a negative balance, there will be no experience credits and, in general, the insurer will be unable to recover its net losses. Under experience-rated contracts, the insurer's potential profits from mortality are limited to the profit margins used in determining the balance in the notional account, along with any difference between its investment return and the interest it credits to the notional account.

As noted above, each insurer may have its own variation in techniques. The techniques may involve adjustments in future charges in lieu of determining experience credits. We have seen versions where the notional account earns separate account performance. For the business that is participating, the credits may be in the form of policy dividends.

At the time coverage is issued, for experience-rated contracts it is customary for the insurer to provide the policy owner with a description of the approach to be used in repricing, and in general the insurer will make commitments on its future use of this approach.

For the remainder of this paper, we will refer to the notional account as the "Mortality Reserve" or "MR".

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When Experience Rating Does Not Apply

When experience rating does not apply, the insurer may choose to establish its charges and perform repricing on the experience of a segment of its business or on the business issued in a given time period, or both; for example, it is common for an insurer to use the same pricing for all of its corporate-owned life insurance ("COLI") or bank-owned life insurance ("BOLI") business issued on a guaranteed issue basis in a given year or group of years. When this is done, it may choose to use a technique similar to the technique used for experience-rated business, but applied to the "pool" of business in the defined segment. As a result of this pooling, the same charges or basis of charges would apply to all insured groups without regard to the experience of each group. Some groups will have lower mortality experience than average and others will have higher mortality experience than average.

If the experience of each group is evaluated after a number of years, the groups with relatively lower claims may feel they have been overcharged while the groups with relatively higher claims may feel they have experienced favorable pricing. The insurer is concerned about its aggregate level of charges more than it is concerned with the experience of a single group.[1] Losses it experiences on some groups may be made up by gains it experiences on other groups. To achieve its target profitability, the insurer may choose to manage this business by evaluating the entire segment in the same manner as has been described for experience-rated clients, or it may use other techniques.

At the time coverage is issued, the insurer may make a commitment on the approach to be used in repricing. However, this is not always done. Absent such a commitment, it may be possible for the insurer to increase its mortality charges, either to increase its profitability or to cover other costs.

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1 The insurer will want to avoid "anti-selection". For example, a group that has lower than average mortality may choose to withdraw from the experience by terminating coverage, which may have an adverse effect on the future experience of the pool. The insurer will prefer to avoid anti-selection, since it results in reduced earnings or the need to raise prices.

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Consequences when Experience Rating Applies

Regardless of the mechanics, when an experience-rating technique applies:

- The insurer profits from mortality charges will be limited based on its defined profit margins;
- Charges for mortality for each group will more closely match the benefits received;
- To the extent mortality claims do not exceed the Mortality Reserve that has been established, P&L impacts to policy owners for each claim are minimal[2] (because the claim cost is charged to the Mortality Reserve that has been established from prior charges);
- The insurer may experience a permanent loss from mortality (for the affected group) because the policy owner can terminate following a period of high claims activity; and
- The degree of risk transfer is reduced compared to a contract that is not experience rated, because losses for a policy owner in one period may be recovered in future periods, in whole or in part, as a result of repricing actions for that policy owner.

Consequences when Experience Rating Does Not Apply

Regardless of the mechanics, when no experience-rating technique applies:

- Policy owner performance is less predictable (deviations from the policy owner's expected earnings are larger) because earnings are impacted by each claim as it occurs;
- There is potential for relative gains if the policy owner's mortality claims are higher than COI charges;
- There is potential for relative losses if the policy owner's mortality claims are lower than COI charges;
- The policy owner's P&L will reflect these deviations, resulting in greater volatility than for experience-rated plans; and
- Any insurer repricing actions (or lack thereof) may be inconsistent with the claims experience of a single policy owner.

2 For an experience-rated plan, all or the majority of the mortality charges are added to the Mortality Reserve, and to this extent there is not an economic loss from the mortality charge. Conversely, when there is a claim on an experience-rated plan, a portion of the claim costs is covered by a charge to the Mortality Reserve, thus reducing the economic gain at the time the claim is processed. As a result, earnings volatility is reduced for experience-rated plans.

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Economic Advantages of Experience Rating

Provided minimum case size criteria are satisfied, a purchaser can decide whether to seek an experience-rated contract. Some insurers offer experience rating for cases as small as 50 insured lives. So, above a minimum case size a policy owner can choose whether to use experience rating either by selecting from options made available by one insurer, or by selecting a different insurer.

Generally, purchasers do not know in advance whether their mortality experience will be higher or lower than the mortality expected by the insurer when setting its charges. Therefore, if they choose a non-experience rated contract, they cannot know in advance whether the charges for mortality will be reasonable in relation to the benefits they will receive. As such, there is a risk that the mortality charges will exceed the benefits received if actual mortality is relatively low, with the result that the benefits from the program will be lower than anticipated costs; depending on the degree of this excess, this difference can be very significant. This risk is counterbalanced by the opportunity to receive benefits that are greater than the mortality charges if actual mortality is relatively high, with the result that the benefits from the program will exceed anticipated benefits; depending on the degree, this can also be very significant. None of the employers we have encountered have ever expressed a desire to profit by employees dying faster than expected. But in the course of evaluating their purchase many employers have analyzed the impact of employees dying slower than expected. In fact, one of the reasons our clients have sought out experience-rated plans is to reduce the risk of losses that would result if they purchase a non-experience rated plan and mortality is lower than expected. For a typical well-funded plan, the COI charges represent the equivalent of 100 to 150 basis points in average rate of return over the life of the program; so a mismatch of only 10% between actual and anticipated benefits may be equivalent to 10 to 15 basis points, and potential deviations are certainly much larger than 10%. Uncertainty of this size is large in comparison to the advantage anticipated in making a purchase decision. The uncertainty in performance introduced by the mismatch between actual benefits and expected benefits is reduced in an experience-rated plan. At the same time, the experience-rating procedure generally puts limits on the insurer's profits from mortality charges.

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Economic Advantages of Experience Rating (cont.)

For smaller cases, it may take many years before the experience results become statistically significant. In these cases it is likely to take a number of years before any experience credits are earned, so some of the positive benefit from experience rating may be deferred. (Value remains in the Mortality Reserve account, but this account may have limitations on asset allocation or earned rate under some product designs.) Therefore, there is a possibility that the Mortality Reserve growth rate will be lower than that of the balance of the policy cash value. Any such lower earnings rates may have an impact on policy performance that is comparable to having higher policy charges; but the insurer is justified in keeping the reserve invested in more liquid, shorter duration assets given its exposure to fluctuations in mortality claims experience that are characteristic for smaller cases.

Excessive Costs Defined

We intentionally exclude from our definition of excessive COI costs increases in mortality-related charges that transpire solely because of unfavorable mortality experience. As previously explained, insurers are entitled to price products to be profitable. Therefore, if mortality experience is substantially worse than "reasonable" expectations set by the actuaries at time of policy issuance, the insurer is entitled to increase COIs accordingly—bearing in mind that the increase should be consistent with future expectations—but only if they are not seeking to use the occasion to justify or disguise increasing overall profitability.

What then are we talking about when we say "excessive" COI costs? While there are several locations in the sand where one could draw a line, we focus on two upper boundaries that should, at minimum, be considered and understood by purchasers. The first, and most egregious, is when the insurer exercises its discretion over mortality-based charges solely to increase its profitability on one or more blocks of policies. The second occurrence is when the insurer increases COI charges to offset non-mortality related deficits to approximate its original overall profitability targets. The latter instance can be as vexing as the first for policy owners under certain circumstances (e.g., when the policy owner was deliberately led to believe that mortality-related charges would only be increased if warranted by unfavorable mortality experience).

The first, and most egregious, is when the insurer exercises its discretion over mortality-based charges solely to increase its profitability on one or more blocks of policies.

Regardless of the source of "excessive COI costs", the impact is limited under experience-rated plans because most if not all of the increase in COI cost is added to the MR, which is ultimately returned to the policy owner. The exposure is far larger with non-experience rated plans, because the entire increase in COI costs inures to the insurer. In both cases, exposures can be quantified, and it is highly advisable for policy owners to understand the extent of their existing exposures as well as potential exposure under contemplated purchases.

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Excessive Costs Defined (cont.)

To demonstrate the potential impacts, we modeled a sample case under a number of scenarios. The sample case was derived as a blend of some actual cases currently serviced by MB Schoen & Associates, Inc. The characteristics of the sample case include:

1. 600 insured lives
2. Coverage has been in force for 10 years
3. The policy is no longer premium paying; the aggregate cash value is approximately 140% of premiums paid
4. The aggregate coverage amount for the sample case is approximately 220% of cash value (this is close to a fully paid-up plan)
5. The insured population was issued at ages 30 through 60, so the insureds' ages currently range from about 40 to about 70
6. The cash value accumulation test is used for compliance with Section 7702 of the Internal Revenue Code

The sample case was modeled using both a non-experience rated approach and an experience-rated approach, under scenarios where the COI rates are continued unchanged as well as scenarios where COI rates are increased to guaranteed maximum levels. The model incorporated the following assumptions (for simplicity and ease of analysis, the product illustrated has a very streamlined policy charge structure):

1. Deaths (at the assumed mortality rate) occur at the end of each month
2. Assumed mortality is at 45% of the 1983 GAM table
3. COI charges are deducted from policy value; the rates used vary by scenario; the baseline COI rates are at 58% of the 1983 GAM table for non-experience rated plans, and at 65% of the 1983 GAM table for experience-rated plans
4. Investment performance is at 4% annually, and it is added to policy value with no asset-based charges (this is equivalent to a general account product with interest credited at 4% annually)
5. For experience-rated plans, interest is credited to the Mortality Reserve at 3.50% annually
6. For experience-rated plans, a retention charge of 5%[3] of the 1983 GAM table is deducted from the Mortality Reserve each month
7. For experience-rated plans, the opening (end of year 10) Mortality Reserve is assumed to be $3.8 Million. This is somewhat less than the target reserve level at that time. The target reserve is the greater of (a) 2 years of COI charges (defined as 130% of the 1983 GAM table rate applied to the current amount at risk for each insured), and (b) the sum of the two largest net amounts at risk for the case. If the the initial Mortality Reserve exceeds the target, there would be experience credits at the beginning of the illustration, but that did not occur in the examples provided.

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3 The retention charge on experience-rated plans in the marketplace (illustrated here at 5%) is typically smaller than the expected margin for non-experience rated plans (illustrated here at 13%, equal to 58% less 45%). The authors believe this is partly due to the larger case size typical for experience-rated plans and partly because the insurer has a better chance to recover losses in one period via gains in subsequent periods under experience-rated plans.

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Excessive Costs Defined (cont.)

The distinctive characteristics and assumptions for each of the scenarios that were run are:

1. Scenario 1N provides a baseline for non-experience rated plans. It used the assumptions above for all plan years.
2. Scenario 1E provides a baseline result for experience-rated plans. It also uses the assumptions above for all plan years.
3. Scenario 2N is like Scenario 1N except that COI rates are increased to guaranteed maximum levels at the beginning of the illustration (at the beginning of policy year 11).
4. Scenario 2E is like Scenario 1E except that COI rates are increased to guaranteed maximum levels at the beginning of the illustration (at the beginning of policy year 11).
5. Scenario 3N is like Scenario 2N except that the face amount is reduced to $1[4] at the beginning of year 11 (when the COI rates are increased).
6. Scenario 4N is like Scenario 3N except that the timing of the increase in COI charges and the reduction in face amount is at the beginning of year 20.
7. Scenario 4E is like Scenario 2E except that the timing of the increase in COI charges is at the beginning of year 20, and the face amount is reduced to $1 at the time the COI rates are increased.

To measure relative performance of the illustrated results under the different scenarios, we use internal rates of return. The internal rates of return[5] for each of these scenarios are shown in the table below:

Table 1 -- Internal Rates of Return for Each Scenario

Scenario 1N	Scenario 2N	Scenario 3N	Scenario 4N
3.78%	2.52%	2.57%	2.84%
Scenario 1E	**Scenario 2E**		**Scenario 4E**
3.939%	3.937%		3.937%

4 Because the product uses the cash value accumulation test for compliance with the definition of life insurance under IRC Section 7702, reducing the face amount to $1 causes the death benefit to be equal to the cash value divided by the net single premium, which provides the minimum coverage needed to satisfy the definition of life insurance (under IRC Section 7702). Reducing the coverage amount allows the policy owner to obtain partial relief from the adverse impact of the increase in COI charges.

5 The internal rate of return has been determined prospectively from the beginning of year 11 over the remainder of the life of plan based on pre-tax cash flows, with the end of year 10 cash value (and end of year 10 Mortality Reserve for experience-rated plans) treated as “invested” at that time. It has also been assumed that coverage on each insured is continued in force until death.

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Excessive Costs Defined (cont.)

We make the following observations based on these results:

1. Scenario 1N provides a baseline for non-experience rated plans. The baseline spread or "frictional cost" of this product as illustrated is 22 basis points (4% credited rate less 3.78% rate of return). This spread can be considered to be the cost of investing in the life insurance program. It is equivalent to the difference between COI charges and insurer claims costs assumed, and can be viewed as representing insurer profits.
2. Scenario 1E provides a baseline result for experience-rated plans. The baseline spread or "frictional cost" of this product as illustrated is 6.1 basis points (4% credited rate less 3.939% rate of return). As with Scenario 1N, this is equivalent to the difference between COI charges and insurer claims costs assumed.
3. Scenario 2N is like Scenario 1N except that COI rates are increased to guaranteed maximum levels at the beginning of the illustration (at the beginning of policy year 11). The spread increased from 22 basis points to 148 basis points. This shows that if the insurer increases its charges to maximum levels it would have a significant adverse effect on earnings for a non-experience rated plan.
4. Scenario 2E is like Scenario 1E except that COI rates are increased to guaranteed maximum levels at the beginning of the illustration (at the beginning of policy year 11). The spread increase (from 6.1 basis points to 6.3 basis points) is minimal for this experience-rated plan, primarily because the increase in charges results in increased experience credits (and not increased insurer profits).
5. Scenario 3N is like Scenario 2N except that the face amount is reduced to $1 at the beginning of year 11 (when the COI rates are increased). This provides a minor improvement in performance as compared to Scenario 2N (the spread is reduced from 148 basis points to 143 basis points), showing that the policy owner's right to reduce the coverage amount has limited value in reducing costs.
6. Scenario 4N is like Scenario 3N except that the timing of the increase in COI charges and the reduction in face amount is at the beginning of year 20. So an increase in charges many years in the future still has a significant (124 basis points) adverse impact on performance.
7. Scenario 4E is like Scenario 2E except that the timing of the increase in cost of insurance charges is at the beginning of year 20, and the face amount is reduced to $1 at the time the COI rates are increased. As with Scenario 2E, the increase in spread is minimal.

To summarize, the reductions in rate of return associated with the non-experience rated plans are quite significant, whether the increase is immediate or deferred for 9 years. The reduction in face amount to $1 does not result in much improvement, which shows that even when the policy owner takes action to minimize the net amount at risk, an increase in COI rates is significant. For the experience-rated plans which have a fully funded Mortality Reserve at the beginning of the illustration, the increase in COI charges is added to the Mortality Reserves, resulting in increased annual experience credits (there are not increased insurer profits under this plan design), and as a result there is minimal deterioration in rate of return performance.

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Excessive Costs Defined (cont.)

One troubling fact about these exposures is that, like locusts, they can lie dormant for years, even decades, before surfacing to wreak havoc. Given that most COLI/BOLI plans have half-lives extending to over 25 years, seemingly benign inexpression during early years can conceal the considerable, troubling consequences.

Insurance companies that remain active players in the COLI/BOLI markets must use exceptional caution before attempting to increase mortality charges because they risk alienating distributors, clients, and prospective customers alike. Those carriers no longer subject to competitive demands (i.e., those that have withdrawn from the market) are far more likely to exhibit unwelcome behavior. This is even more likely to occur, and to a more injurious degree, after new management is given oversight of a closed block of business. Incoming management may not have an existing relationship with clients or brokers. It isn't difficult to imagine that they may feel less constrained by client loyalty and therefore more prone to pursue all available means for increasing profitability.

Given that most COLI/BOLI plans have half-lives extending to over 25 years, seemingly benign inexpression during early years can conceal the considerable, troubling consequences.

Recent Cases in Point

We believe the norm is that carriers adjust their mortality charges based on changes in mortality experience. Consistent with this, we are aware of at least one carrier that has limited changing its COIs in keeping with its expectations regarding mortality experience. This practice happened to result in a significant reduction in COIs. The carrier specialized in experience-rated plans for larger COLI/BOLI plans but had accumulated a large block of pooled mortality cases. A fair amount of conservatism was built into the COI rates the carrier initially charged for the pooled cases. Once there were sufficient lives insured and adequate years of experience to reassess COI rates, rates were reduced for all policy owners and have remained at the lower level for over 8 years.

We are also aware of some deviation from this norm.

For well over a decade a carrier we'll call "Company X" was a significant player in the general account and separate account BOLI markets until completely withdrawing from the BOLI market in 2010.

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Recent Cases in Point (cont.)

In December 2013 Company X announced to its clients and brokers that it would be increasing COIs beginning in early 2014.[6] Among other things, Company X stated: "Due to the persistently low interest rate environment, cost of insurance rates on general account policies written or serviced by the [Company X] COLI/BOLI Service Center will increase."

The economic impact of Company X's action varies depending on the insured census and purchase date of each plan, but in all cases it has been very significant. The observed impact on overall performance has been in the range of 20 to 70 basis points, and the impact is expected to increase over time as the insured populations age.

More recently, in early 2016, another carrier we'll call "Company Y" informed its BOLI policy owners of a similar impending COI rate increase:

> Beginning on your first monthly deduction date on or after April 1, your policy's cost of insurance (COI) rates will increase. The COI changes comply with the terms of the policy(ies). As a result of this change, your monthly deduction will increase and your cash value growth rate will decrease.
>
> [Company Y] does not take these actions lightly. As a reflection of our commitment to our policy owners, we have been maintaining COI rates during a time of historic low interest rates. However, these adjustments are necessary based on material changes in future expectations of key cost factors associated with providing this coverage, particularly lower investment income in today's low interest rate environment.[7]

Of note, unlike Company X, Company Y remains active in BOLI and COLI markets.

Both the Company X and Company Y BOLI policies contained contractual provisions maintaining broad control over increasing COI rates. For example, one of Company Y's BOLI policies included the following language:

> The monthly cost of insurance rates are determined by us. Rates will be based on our expectation of future mortality, interest, expenses, and lapses. Any change in the monthly cost of insurance rates used will be on a uniform basis for Insureds of the same rate class. Rates will never be larger than the maximum rates shown on page…[8]

Company X stated: "Due to the persistently low interest rate environment, cost of insurance rates on general account policies written or serviced by the [Company X] COLI/BOLI Service Center will increase."

6 Company X's COI rate increase was announced in a December 9, 2013 letter from the company's COO and Relationship Manager within the Company X COLI/BOLI Service Center.
7 Company Y's COI rate increase was announced in a March 15, 2016 letter from an affiliate of Company Y.
8 Policy Form 94-310 (originally issued by that affiliate of Company Y and assumed by Company Y).

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Recent Cases in Point (cont.)

Note that the requirement that changes be applied on a uniform basis does provide some protection to policy owners (i.e., it suggests Company Y cannot apply changes on a discriminatory basis). Illustrations our clients have received from Company Y suggest that the COI increase is temporary, projected to revert back to the original rates 5 years after the initial increase. Data on actual charges has been consistent with a subsequent decrease in rates, and Company Y has provided a schedule which predicts further decreases. Of course, Company Y could elect to extend the period of the increase, but in theory at least all policy owners will be treated in a uniform manner.

One of Company X's BOLI policies included the following language:

> The monthly rates that apply to the cost of insurance for the initial Face Amount at all ages will not be greater than the maximum rates shown in the Table of Guaranteed Maximum Monthly Cost of Insurance Rates attached to this policy. We will set the actual rate applicable, in advance, at least once a year. Any change in the cost of insurance rate will be on a uniform basis for all Insureds of the same classification, such as, attained age, sex and risk classification.[9]

Considering the generous discretion retained by each carrier over setting COI rates, it is difficult to lay all of the responsibility with them. Policy owners and their respective advisors could have secured better contractual terms and in turn better outcomes.

By actually raising COIs, Company X and Company Y have become industry outliers; unfortunately for most GA BOLI owners, many other insurers that offer GA BOLI products retain the discretion to increase COIs for reasons other than mortality experience.

MB Schoen & Associates, Inc. performs an annual study that contrasts insurer net yield (as published by A. M. Best in its Annual Key Rating Guide)[10] and Annual Net Return on Assets of Policy Cash Values for business MB Schoen & Associates services. One aspect of that study is a graph that plots the difference between these two measures. Due to lack of comparability of data, this study is merely indicative and does not provide any absolute results. However, the following graph from that study is instructive; it clearly shows effects from Company X's change, which was announced in 2013 and effective in 2014. The results for each of A, B, C, and D incorporate the average for a collection of companies, other than Company X. The other 20 companies have been grouped into four cohorts representing relative historic spread levels. We do not yet see effects from the Company Y change, which was announced in 2016 and, as noted above, appears to be temporary.

9 Policy Form 1-11811199

10 A. M. Best defines "net yield" as "net investment income expressed as a percentage of mean invested assets and accrued investment income, less borrowed money. It does not reflect the impact of realized and unrealized capital gains or income taxes." Note that the net yield reflects the insurer's return on its entire portfolio of assets, whereas the credited interest rate may be based on a segment of the portfolio.

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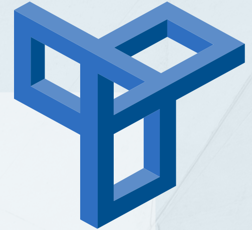
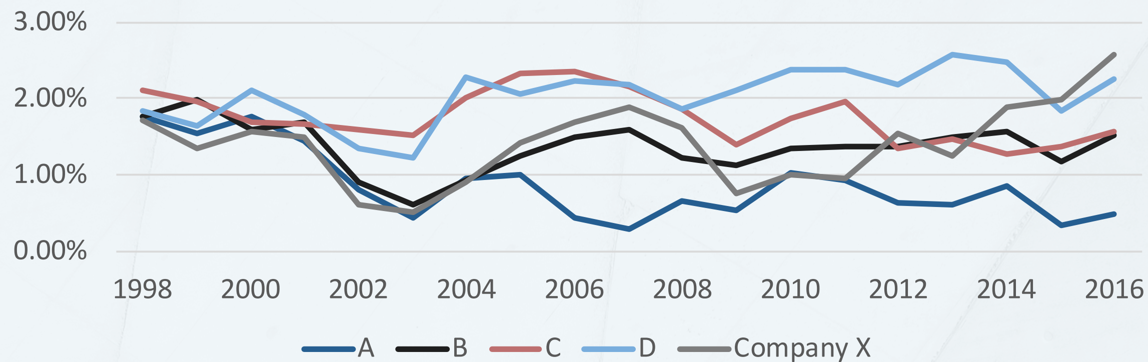
Recent Cases in Point (cont.)





When viewing the graph, keep in mind that earned interest rates on new investments dropped substantially after the financial crisis that began in 2008, and since that time have generally been less than guaranteed minimum credited interest rates. The graph indicates that the majority of companies experienced some spread compression over this period. Prior to its COI rate increase (through 2013), Company X was in the majority.

Considering the generous discretion retained by each carrier over setting COI rates, it is difficult to lay all of the responsibility with them. Policy owners and their respective advisors could have secured better contractual terms and in turn better outcomes.

The graph suggests that in the immediate aftermath of Company X's COI rate increase, its spreads increased by approximately 50 basis points (from approximately 2% to 2.5%). Although it's impossible to empirically determine whether and to what degree the recovery in spread above the policy crediting rate is attributable to the COI increase, it seems reasonable to assume some portion can be credited to this action. As rates rise and Company X is in position to achieve its targeted spread on investment returns it will be interesting to see whether they lower COIs or increase crediting rates.

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Approaches to Minimize Excessive Mortality Costs

By now it likely appears obvious that the authors strongly favor policy purchasers securing experience-rated mortality designs whenever facts and circumstances permit (subject to the other considerations discussed, including size and demographic composition of insured population, and risk transfer).

But it bears stating that experience rating in and of itself doesn't eliminate exposure to excessive COI costs. The devil remains in the details, and even with experience rating there are approaches that provide at least some exposure to unanticipated costs.

...experience rating in and of itself doesn't eliminate exposure to excessive COI costs.

As Table 1 above demonstrates, the exposure for non-experience rated plans is significantly greater, so far more attention is warranted on how to minimize excessive COIs in non-experience rated plans. The balance of this section is therefore devoted to improving outcomes of pooled mortality designs.

The most fundamental step in the direction of minimizing excessive costs with pooled mortality designs is to obtain written assurance that the carrier will only change COIs based on changes to mortality experience and expectations of future mortality experience.

There are many ways this can be documented. Unambiguous language within the policy would seem the ideal starting point. However, seemingly unambiguous policy terms may not always be sufficient. Consider the 2012 lawsuit *Norem v. Lincoln Benefit Life*.[11] Dennis Norem, M.D., who purchased a variable life policy from Lincoln Benefit Life, filed a putative class action against Lincoln Benefit claiming it breached the terms of the policy by the method it deployed in calculating COIs. The policy stated, as quoted by the court in relevant part: "The cost of insurance rate is based on the insured's sex, issue age, policy year, and payment class. The rates will be determined by us, but they will never be more than the guaranteed rates shown on Page 5.[12]"

In essence, Norem alleged that Lincoln Benefit broke the terms of the policy when it considered factors beyond the insured's sex, issue age, policy year, and payment class when calculating the COI rates. Although Lincoln Benefit admitted that, when establishing COI rates, it utilized numerous additional factors (i.e., beyond those enumerated in COI section of the policy) nevertheless its COIs were still "based" on those same enumerated factors because they still had significant influence on the COI rate calculation.

11 United States Court of Appeals for the Seventh Circuit, No. 12-1816.
12 Universal life policies contain a table of guaranteed maximum cost of insurance rates. Evidently the table contained in this policy is on page 5.

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Approaches to Minimize Excessive Mortality Costs (cont.)

The district court granted summary judgement in favor of Lincoln Benefit, a decision later upheld by the U.S. Court of Appeals for the Seventh Circuit. The judges reasoned that if the insured's sex, issue age, policy year, and payment class were principal components of the COI rate calculation, they need not be the exclusive factors used in setting them. Key underpinnings of their logic are summarized as follows:

> Most notably for our purposes, none of the definitions lends itself to Dr. Norem's proposed interpretation: that "base" or "based on" implies exclusivity... no one would suppose that a cake recipe "based on" flour, sugar and eggs must be limited only to those ingredients. Thus, neither the dictionary definitions nor the common understanding of the phrase "based on" suggest that [the insurer] is prohibited from considering factors beyond [the enumerated factors of] sex, issue age, policy year and payment class when calculating its COI rates.

Thus, the judges viewed sufficient ambiguity stemming from inclusion of the words "based on" to effectively open the door to Lincoln Benefit having broad discretion to use additional factors.

When negotiating terms with a carrier on behalf of clients purchasing hundreds or even thousands of policies, we often advise taking steps beyond reviewing the policy language. What does one do when the policy, when viewed in isolation, grants far more latitude to the carrier? Our clients have been able to obtain side letters, sometimes referred to as letters of understanding, that clarify and/or modify terms or costs inadequately or unfavorably covered in the policy itself. These can provide important additional protections to both parties and are often necessary to assure institutional clients aren't settling for an inadequate, off the shelf solution. Supplemental agreements, endorsements or similar, legally enforceable documents can include detailed explanations regarding what circumstances will and will not justify future COI increases, something that is absent from the provisions of too many policies.[13]

Our clients have been able to obtain side letters, sometimes referred to as letters of understanding, that clarify and/or modify terms or costs inadequately or unfavorably covered in the policy itself.

13 It is important to establish these legally enforceable documents at the point of policy issuance, because changing legally enforceable terms subsequent to policy issuance may give rise to material changes that have adverse consequences for policy owner tax purposes.

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Approaches to Minimize Excessive Mortality Costs (cont.)

It is also advisable to obtain, prior to purchase, a full and authenticated copy of the policy filing applicable to ones' contemplated purchase (i.e., for the product as it was filed in the state where the policy is to be purchased). Among other things, the filing may include an actuarial memorandum which typically sets forth what are known as "non-guaranteed elements" and "determination procedures" for changing these elements of policy pricing in the future. Where an actuarial memorandum is not available or does not contain such determination procedures, it is possible the carrier has alternative documentation on these procedures which can be made available. These determination procedures will reveal whether the carrier has retained the right to increase COI's for non-mortality-based reasons and may therefore be instructive regarding the extent additional written warranties are called for.

When supplemental documentation is advisable we work closely with our clients' counsel to obtain the most suitable forms for each transaction.

Regulatory Limits on Increases in Cost of Insurance Charges

On September 5, 2017, New York promulgated Insurance Regulation 210.[14] This regulation "establishes standards for the determination and readjustment of non-guaranteed elements that may vary at the insurer's discretion for life insurance policies and annuity contracts delivered in [New York], and to ensure that policy forms do not contain provisions that may mislead policy owners as to the crediting of non-guaranteed amounts or the deduction of non-guaranteed charges, and to ensure that the issuance of any policy forms would not be prejudicial to the interest of owners or members or contain provisions that are unjust, unfair or inequitable." Because many insurers write business with the same pricing in New York and in other jurisdictions, this regulation may have an extra-territorial effect on insurer behavior.

Regulation 210 was effective as of March 19, 2018. It does apply to future changes in non-guaranteed elements with respect to business issued before this date. However, Regulation 210 does not apply to corporate and bank owned life insurance, so it may not have an effect on non-guaranteed elements for COLI and BOLI plans (it appears the industry succeeded in lobbying for a specific exemption).

14 New York State Department of Financial Services, 11 NYCRR 48 (Insurance Regulation 210).

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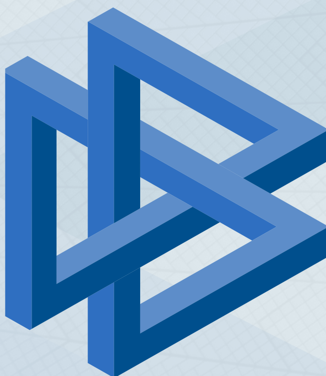
Regulatory Limits on Increases in Cost of Insurance Charges (cont.)

One aspect of this regulation is that, “At the time of revision of a scale of non-guaranteed elements … , the difference from the point in time of revision and application of the revised scale and the scale in effect at the later of the date of issue or the date of last revision, shall be reasonably based on the difference from the point of revision of the anticipated experience factors underlying the two scales with respect to expenses, mortality, investment income and persistency.” The regulation prohibits increases in profit margins, unless they are approved by the superintendent after finding the increase is necessary due to the financial condition of the insurer. The regulation requires any adjustments made to existing policies to be based on expectations as to future experience and not made in order to recoup past losses. (Experience factors from the date of the last prior revision up to the date of the new revision will be assumed to equal the anticipated experience as of the date of the last prior revision.)

We are not aware of any effective regulation of changes in non-guaranteed elements, including cost of insurance charges, in any other jurisdiction. Insurers could decide to voluntarily follow the requirements of Regulation 210 for all of their business, including COLI and BOLI. It remains to be seen whether this new regulation will have an effect on future insurer rate actions for this business. While the regulation is not directly applicable to COLI/BOLI plans, it is possible that many carriers will consider the requirements of this regulation when changing non-guaranteed elements on COLI/BOLI products. It provides an excellent framework for buyers to avoid being gauged by carriers’ current or future management while granting the insurer a rationally defensible degree of latitude in adjusting non-guaranteed elements over the life of a policy.

It remains to be seen whether this new regulation will have an effect on future insurer rate actions for this business.



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About the Authors

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Matthew Schoen is founder and president of MB Schoen & Associates, Inc. (MBSA), founding principal of Private Placement Insurance Products, LLC (a FINRA B/D), Concept Hedging, LLC and DC Plan Insurance Solutions, LLC. Matt has over 25 years' experience working with banks, insurance companies and other financial institutions with special regulatory and accounting considerations with BOLI/COLI plans.

MBSA has developed several proprietary software systems, including CARS™, which it uses to perform automated, reconciliations of insurance carrier reported charges and values. MBSA presently administers over $23 billion of BOLI. As co-founder of Concept Hedging, LLC, and DC Plan Insurance Solutions, LLC, Matt is inventor or co-inventor on over a dozen U.S. patents related to insurance and financial products, including 401KSecure™, several risk mitigation and risk shifting innovations in the field of financial guarantees, including stable value protection (SVP). Prior to founding MBSA in 1992, Matt started and managed the Corporate Life Division for a major international insurance company, was President and Chief Compliance Officer of Westport Benefit Resources and served as a National Executive Compensation Specialist for Merrill Lynch.

Jim Van Etten

Jim Van Etten is Managing Partner of Van Etten Actuarial Services, LLC. Jim formed Van Etten Actuarial Services, LLC, in 2014 to provide consulting services to the life insurance industry, particularly with respect to product development and related services for corporate owned life insurance (COLI) products.

Previously, Jim was employed by The Mutual Benefit Life Insurance Company, Hartford Life Private Placement (formerly International Corporate Marketing Group, and an affiliate of Hartford Life Insurance Company), and Philadelphia Financial Administration Services Company (now known as Lombard International Administration Services Company). His early experience included product development, product management and development of administrative systems for individual life and disability income products. More recent experience has principally been related to product development, product and financial management and development of administrative systems for COLI products. His interests and expertise encompass general account and variable (including private placements) life insurance and annuity products for individual and corporate policy owners, life insurance and annuity product taxation, insurance company taxation and life reinsurance.

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