Life Insurance Policyholder Protection: Who's Got Your Back?

By R. Marshall Jones
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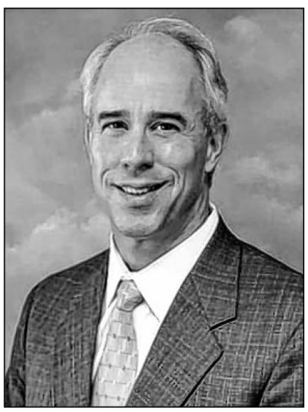
In his 2010 book *The Big Short*, Michael Lewis detailed how some life insurance companies were big losers with sub-prime mortgages. Today, with continued worldwide economic uncertainty and the United States' loss of its AAA rating from Standard and Poor's in 2011, many people are asking: Who's got my back? How safe are my life insurance guarantees and expected cash values? How will my policy perform? What resources can I use to stay on top of the issues? This article will help answer those questions.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The Good News

For more than 100 years, every U.S. contractual life insurance death benefit has been paid. Even when insurers failed, the regulators have stepped in and the insurance companies have stepped up to protect the insurance company's assets for the benefit of the policyholders and pay the full contractual death benefits. This is particularly good news for owners of "guaranteed life" policies who may think of these contracts as the equivalent of a zero coupon bond that matures in full at death. The death benefit guarantees are fully reserved to assure payment even though the cash surrender value may reduce to zero. By comparison, the AAA corporate bond rating doesn't provide protection for bond holders if the corporation defaults

■ **State Regulatory Protection:** Proper reserving, statutory accounting practices, outside actuarial audits and continual oversight protect your insurance guarantees. In 1905, state regulators began requiring insurers to establish sufficient reserves to honor their contractual guarantees. Using statutory accounting practices, today's financial statements certify the required conservative assumptions to maintain solvency. In essence, they say: "If we stop selling new insurance, we have sufficient investment grade assets to support every old life insurance policy on our books." Life insurers are required to file quarterly financial statements with a focus on solvency rather than profits and with stress testing to identify liquidity risks that may require additional reserves.

Some life companies are subsidiaries of holding companies. In effect, the regulations create a wall to prevent the insurer from upstreaming capital, surplus and required reserves to the parent company

■ **State Law Protection:** State laws provide additional policy-owner protection. The "full faith and credit" of the life insurers' "general account" assets support the contractual guarantees in traditional life insurance policies. This includes a significant, mandatory capital and surplus cushion comprised of safe assets available to, for example, fix any reserving mistakes. When sub-prime mortgages were no longer investment grade, insurers were required to set aside additional "asset valuation reserves."

When a life insurance company fails, the insurer's general account assets are frozen and policyholder claims have first priority over general creditor and bond holder claims. Typically, the conservator will rehabilitate the insurance company or structure an arrangement for the transfer of policies with matching reserve assets to a financially strong insurance company

■ **Separate Account Policy Protection:** The cash values of variable life policies are exempt from the creditors of the life insurance company and are segregated from the insurer's general account portfolio. The actual level of protection varies from state to state.

The Not-so-good News

When an insurer becomes insolvent, the general account cash values are generally unavailable for a period of time, the crediting rate may be reduced to the guaranteed rate and the assets may not be sufficient to fully guarantee the cash surrender value.

■ **State Guaranty Funds:** In a worst case scenario with an insolvent carrier, all 50 states as well as the District of Columbia and Puerto Rico have state guaranty funds with limited funds to pay policyowner benefits. Typically, the State Guaranty Fund will only protect up to $100,000 of cash value and $300,000 of death benefit. Although in recent insolvencies, more than 90 percent of policyholders have been covered in full, the State Guaranty Fund provides little protection for a large value policy

■ **Screening and Diversification:** The risk of insurance company failure can be reduced by establishing minimum acceptable sizes — in billions of dollars — and financial strength ratings. For example, of the 400 life insurance companies in the United States, the top 30 companies issue 80 percent of large death benefit policies. Additional safety can be obtained with diversification by company and by policy type.

■ **Policy Selection and In-force Policy Management:** When policy performance is tied to non-guaranteed assumptions, carrier and product selection and in-force policy management become even more important. In too many cases, policyholders have been subjected to a history of failed promises. Always remember that the illustration is not the contract. Instead, the basic pricing elements — mortality, expense, investment earnings and persistency — often are hidden in a black box called the life insurance contract. A carefully selected insurance adviser can help open the black box, crack the secret code and provide planning and product solutions with the necessary ongoing client advocacy and in-force management.

R. Marshall Jones is a founding principal of Jones Lowry, an independent life insurance planning firm specializing in the design, implementation, funding and administration of life insurance portfolios for ultra-affluent families. Marshall is a non-practicing member for the Florida Bar and an Accredited Estate Planner, Chartered Life Underwriter and Chartered Financial Consultant. Jones Lowry is online at