



By **Michael B. Liebeskind**

Key Trends in Life Insurance and Annuity Markets

Significant developments will affect pricing and performance

Analysts and rating agencies generally view the life insurance industry outlook as relatively stable, characterized by strong balance sheet fundamentals, stable operating performance and modest growth. Senior life insurance company executives are optimistic that Republican control of the White House and Congress will result in higher interest rates, lower corporate income taxes and less regulation. In addition, life insurance companies continue to implement new technologies to drive cost efficiencies and enable new opportunities. This optimism is dampened to an extent by the potential repeal of estate taxes, which have been an important driver of life insurance sales to high-net-worth clients.

Within this framework, significant developments are occurring that will impact the pricing and performance of life insurance and annuity products. Professional advisors, and especially fiduciaries, have a responsibility to be aware of these developments and to evolve their own perspectives as they counsel clients on the potential utility of the various forms of annuity and life insurance policies available in the market.

Here are some of the key trends in the life insurance and annuity markets.

Higher Pricing

Despite the potential for higher interest rates, there continues to be pricing pressure for life insurance policies whose premium payments are invested in life insurance company general investment accounts. These accounts

are highly regulated, and nearly all major life insurance companies invest 85 percent to 95 percent of their general account assets in fixed income securities, with high credit quality and an average duration of seven to 13 years. Life insurance companies are complex financial institutions, but their performance over time is driven largely by the spread between what they earn on invested premiums and what they pay out to policyholders in the form of increases in cash surrender value and/or death benefits. The 10-year Treasury bond has yielded less than 5 percent for the past 13 years and less than 4 percent for the past nine years. Lower interest rates put pressure on life insurance companies to increase premium pricing, subject to two basic constraints: 1) pricing guarantees embedded within specific life insurance products, and 2) competitive market forces.

The pricing for 10-year, 15-year and 20-year guaranteed premium term life insurance is holding steady for newly issued policies, as the impact of persistently low interest rates (which reduce the return that life insurance company general investment accounts can earn on premium payments) is being offset by favorable mortality experience and intense competition.

The pricing for guaranteed premium universal life (GPUL), which can be thought of as term life insurance that lasts for an insured's entire lifetime, continues to increase for newly issued policies. And, there are fewer competitors, as profit margin pressures have caused some of the major life insurance companies to withdraw from the market. Nonetheless, GPUL policies can still generate a tax-free return (premium outflow versus death benefit inflow) of 4 percent to 5 percent at a fairly measured life expectancy. Inforce policy management is crucial, however, because the guarantees are contingent on the premiums being paid on time.



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The pricing for whole life and universal life is increasing for both newly issued policies and inforce policies, as the life insurance companies continue to exercise their pricing discretion to reduce interest crediting rates and increase expenses. Reductions in interest crediting rates for inforce policies can have a significant impact on the size or number of premiums required to maintain the life insurance coverage for the anticipated duration, and policies that aren't carefully monitored could inadvertently lapse prior to the death of the insured. Recent increases in policy expenses have triggered several class action lawsuits, and the courts will ultimately decide how much actuarial justification, if any, is required for life insurance companies to increase cost of insurance (COI) charges and/or administrative charges.¹

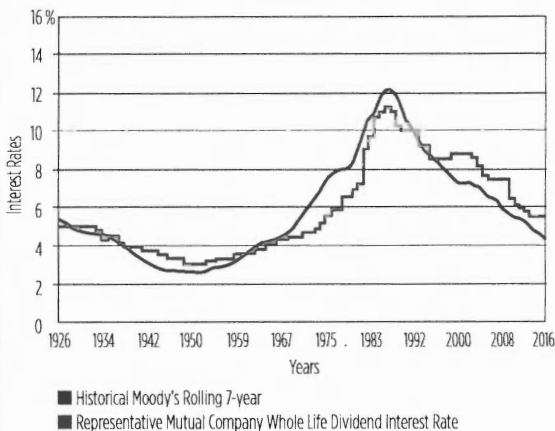
Over the past 90 years, life insurance policy interest crediting rates have tended to lag behind the general rising and falling interest rates environments because it takes a long time for the existing fixed income holdings in life insurance company general investment accounts to be diluted by new investments. (See "Historical Interest Rates," this page.) As a result, we're expecting life insurance companies to continue to increase non-guaranteed pricing, even if the Fed raises interest rates over the next several years. (For more information about the increased costs of insurance, see "What's Behind the Increase in Cost of Insurance Charges?" by Melvin A. Warshaw, in the April 2016 issue of *Trusts & Estates*, p. 26.)

Technology is impacting many industries, and the life insurance market is no exception. Advances in medical technology have continued to increase life expectancies, and the potential convergence of various technologies, such as artificial intelligence, data mining, machine learning, robotics, 3D printing, sensors and material sciences, could lead to dramatic breakthroughs in human longevity. Clients and their professional advisors should keep these advances in mind when reviewing policy maturity provisions (many older policies terminate automatically at age 95 or age 100, resulting in potential adverse income tax and/or economic outcomes) and when reviewing long-term policy economics (internal rate of return and funding adequacy).

Advances in technology are already enabling life insurance companies to issue policies with ever-in-

Historical Interest Rates

Life insurance companies are expected to increase non-guaranteed pricing



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creasing face amounts without performing traditional underwriting procedures, such as insurance physicals and reviews of attending physicians' reports. As confidence in technology-driven alternative underwriting expands through experience, the life insurance companies will eventually be able to issue policies faster and cheaper, with nothing required other than electronic authorizations from the insured and policyowner. This change should democratize life insurance coverage for buyers of smaller policies, who are currently underserved by insurance agents and, therefore, underinsured for even their most basic family protection needs.

Retail Variable Universal Life

Starting in the mid-1980s, life insurance companies began to offer retail variable universal life (RVUL) policies, whose premiums could be allocated by the policyowner among a series of registered investment vehicles² managed by top-tier mutual fund companies. The growth of RVUL was fueled by the bull market in equities that lasted from 1982 through 2000. RVUL market share peaked at 36 percent in 2000 and then declined to 14 percent by 2005 and to 6 percent in 2015.³

Inforce RVUL policies should be carefully monitored,



because policies acquired during the peak sales period of 1995 to 2005 may have experienced several sharp declines in cash surrender value as a result of the 2001 technology bust, the 2008 financial crisis and the 2015–2017 broad market volatility. Moreover, it's now clear that for RVUL policies funded with minimum level premium payments and correspondingly high amounts of life insurance risk, the impact of volatility of returns can also be quite negative in terms of long-term performance. When cash surrender value declines for RVUL policies with fixed death benefits, the net amount at risk to the insurance company (and corresponding cost of insurance charge) increases, reducing the cash surrender value still further. Thus, volatility of cash surrender value can have the effect of amplifying the results.

For example, in 2008, our firm performed a study in which we integrated Monte Carlo analytics into a series of inforce illustrations for an RVUL policy acquired by a client in the early 1990s.⁴ The policy was illustrated to remain in force throughout the insured's life expectancy based on the 7.9 percent annual straight-line return assumption provided by the client's investment advisor. When we applied the Monte Carlo analytics, the volatility of returns (based on a 13.10 percent standard deviation assumption provided by the client's investment advisor) caused the policy to lapse prior to the insured's life expectancy more than 50 percent of the time. In our experience, many insurance agents, professional advisors and fiduciaries still aren't considering the effect of volatility in their evaluation of the funding adequacy of RVUL policies.

Actuarial Guideline 49

Effective Sept. 1, 2015, indexed universal life (IUL) product illustrations became subject to Actuarial Guideline (AG) 49. This regulation was a response to the tremendous increase in sales of IUL, whose premium has grown tenfold since 2004, and a perception that IUL illustrations weren't appropriately reflecting the results that could reasonably be expected from this type of policy structure.

IUL uses derivatives to provide returns that are driven by the equity market, but are collared by a floor and a ceiling to dampen annual return volatility. The cost of these derivatives has a significant impact on expected IUL policy returns, a fact that was often overlooked in

the marketing of this highly complex product. Prior to the implementation of AG 49, it was common for IUL policy illustrations to assume investment returns of 8 percent or higher, mirroring what might be considered a reasonable return expectation for the equity market as a whole. However, it wasn't widely understood that the expense of both the upside derivative (a call option) and the downside derivative (a put option) would reduce the return, as would the fact that the derivatives don't benefit from equity market dividends.

Under AG 49, the maximum illustrated return of an IUL policy has to be based on a back-testing that takes into account the specific upside participation and downside protection terms of the policy. That back-testing demonstrates that IUL results can be significantly lower than general equity market returns. For example, an AG 49-compliant illustration for a competitively priced IUL product would show a maximum return of approximately 6.5 percent, based on a back-testing for the period 1950 to 2015. Over that same timespan, the S&P 500 (including dividends) generated a return of 11.26 percent.

Retail Variable Annuities

The huge retail variable annuities (RVA) market, which has approximately \$1.7 trillion in assets, is subject to emerging market realities and regulatory forces that could turn out to be highly disruptive.

For many years, the features offered within RVAs (including long-term investment return guarantees and life insurance protections) became more and more generous, as life insurance companies competed for market share. During the 2008 financial crisis, the incremental reserves required by these features exacerbated the balance sheet pressures life insurance companies were already facing. Since then, RVA features have become less generous.

Distributors of RVA products generate a significant share of their commission income from rolling inforce RVAs into newly issued RVAs (once the surrender charges diminish, or burn off altogether, after eight to 10 years). The emerging market reality is that for the first time, a client's existing RVA product may have better features than a newly issued one. It's not yet clear how the distributors of RVA products will respond to this challenge, but it's likely to spawn disruptive innovation.



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Against this backdrop, the Department of Labor appeared to be on the verge of issuing regulations that would have subjected distributors of variable annuities to a fiduciary standard, which would have made it very difficult to maintain the current RVA upfront commission model. The implementation of the Department of Labor Fiduciary Rule has been delayed under the direction of President Trump, and its ultimate fate has become somewhat uncertain. Nonetheless, major distributors continue to make plans to comply with the Fiduciary Rule, and that requires a significant re-tooling of existing business models.

Insurance companies have already started experimenting with no-commission RVA products, under which the insurance company receives a retrocession (that is, revenue-sharing arrangement) from the underlying investment funds, and the distributors receive asset-based compensation from the clients. In addition, for qualified purchaser clients with investment assets in excess of \$5 million, distributors can utilize Private Placement Variable Annuity (PPVA) policies, described in more detail below.

Stabilized Life Settlement Market

The life settlement market has undergone tremendous changes over the past 10 years and has now stabilized in terms of both pricing and regulatory scrutiny. Prior to the financial crisis, the life settlement market's rapid growth was fueled by easy credit, a desire among sophisticated investors for non-correlated investment returns that appeared to be relatively safe and a lax regulatory environment. Life settlement promoters openly suggested that life insurance companies were mispricing mortality risks, and that view was supported by aggressive life expectancy estimates from third-party assessment companies. The result was very attractive offers to policyowners for inforce policies and for new policies that were being acquired specifically to flip into life settlement pools.

The financial crisis shut down the easy credit, life insurance companies and state regulators shut down the abusive life settlement sales practices and life settlement investors were generally disappointed with the results.

What's emerged is a new, more responsible life settlement market, in which life expectancy assessments are more realistic (and nearly identical to what a life

insurance company would predict), and the offers made to policyowners are much less generous. We expect the sale of policies to life settlement companies to remain a viable alternative to policy surrenders, but only for smaller policies that can offer life settlement investors a broadly diversified portfolio of policies acquired at reasonable pricing.

PPVA and PPVUL

Private placement variable annuity (PPVA) and private placement variable universal life (PPVUL) policies have been marketed in the United States since the mid-to-late 1990s. These policies use the same tax rules as RVA and RVUL policies and the same access to a series of registered investment vehicles. However, PPVA and PPVUL policies also enable qualified purchasers⁵ to access non-registered investment vehicles (referred to as "insurance-dedicated funds" (IDFs)),⁶ which are managed by top-tier hedge fund, private equity and real estate managers.

The PPVA and PPVUL markets took a sharp upward turn in 2015. There are no reliable industry statistics, but from 2003 to 2014, our firm implemented an average of approximately 15 to 20 new PPVA and PPVUL policies per year. In 2015–2016, we implemented approximately 160 new PPVA and PPVUL policies.

This growth is directly attributable to the expiration of the Bush tax cuts at the beginning of 2013, which increased the taxes payable on investment income for qualified purchasers, many of whom filed their 2013 income tax returns in October 2014. (See "Investment Income," p. 5.)

The growth has also been facilitated by a steady stream of guidelines published by the Internal Revenue Service that have helped responsible market participants gain a clear understanding of how to structure PPVA and PPVUL policies and IDFs. In a seminal 2015 case, *Webber v. Commissioner*,⁷ the Tax Court affirmed the enforceability of the investor control doctrine and specifically mentioned the following pronouncements as being entitled to deference and weight, so professional advisors should take heed of them:

- Revenue Ruling 2003-91
- Rev. Rul. 2003-92
- Private Letter Ruling 201105012 (Feb. 4, 2011)



Investment Income

Tax rates have risen

	2012	Present	% Increase
Federal rate on ordinary income	35.00%	44.60%*	27.43%
Federal rate on capital gains	15.00%	25.00%*	66.67%
Federal rate on dividends	15.00%	25.00%*	66.67%

* Includes 3.80% to account for Medicare Contribution Tax and 1.20% to account for Limitation on Itemized Deductions (Pease Amendment).


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- PLR 200420017 (May 14, 2004)
- PLR 9433030 (Aug. 19, 1994)
- Chief Counsel Advice 200840043 (Oct. 3, 2008)

The increase in client demand for PPVA and PPVUL policies and IDFs has triggered a virtuous circle that's accelerating the market growth. The more premiums clients deposit into PPVA and PPVUL policies and allocate to IDFs, the more top-tier investment firms create IDFs to capture allocations from those premium deposits. The more attractive the IDF investment offerings, the more new clients acquire PPVA and PPVUL policies. The increase in client demand has attracted wirehouses, private banks and registered investment advisor firms, as well as encouraged more life insurance agents to enter the market.

The potential for a significant reduction in tax rates under the Trump Administration has created some uncertainty, but even with that uncertainty the momentum in the PPVA and PPVUL markets has continued to grow.

We expect that 2017 will be characterized by the entry of new market players, particularly insurance agents who'd previously eschewed the asset-based fee model of PPVA and PPVUL policies for the transaction-based commission model of RVA and RVUL policies. The transition to asset-based revenues is going to be difficult for many insurance agents to sustain, and the infrastructure demands of PPVA and PPVUL policies, which are significantly greater than they appear on the surface, may result in disappointment in terms of the delivery of expected services. As always, clients

and their professional advisors are well advised to perform extensive due diligence before making decisions about counter-party relationships that will need to perform consistently and effectively for many years to come. 

Endnotes

1. Recent court cases involving litigation about cost of insurance charges include: *Celedonia X. Yue et al. v. Conseco Life Insurance Company*, Case #2:11-cv-09506 (S.D. Cal.) and *In re Conseco Life Insurance Company LifeTrend Insurance Sales and Marketing Litigation* MDL No. 3:10-md-2124; *Fleisher v. Phoenix Life Insurance Company*, Case # 1:11-cv-08405 (S.D.N.Y. April 29, 2014); *Brach Family Foundation v. AXA Equitable*, Case #1:16-cv-740 (S.D.N.Y.) (as of publishing date, no decision reached); *Besen Parkway v. John Hancock*, Case #1:15-cv-9924 (S.D.N.Y.) (as of publishing date, no decision reached); *Thao v. Midland National Life Insurance Company*, No. 2:09-cv-01158-AEG (E.D. Wisc. 2013), *aff'd* Nos. 13-1272 and 13-2366 (7th Cir. Dec. 13, 2013); *Norem v. Lincoln Benefit Life Company*, 2012 WL 1034495, No. 1:10-cv-2233 (N.D. Ill. March 20, 2012).
2. Investment Company Act of 1940 (ICA) Section 2(a)(17) and Section 3(c)(3).
3. U.S. individual life insurance sales trends, 1975–2015, LIMRA.
4. Monte Carlo analytics have been performed for retail variable universal life policies as far back as 2005. Peter Katt, "Using Monte Carlo to Assess Variable Life," Financial Planning Association, *Journal of Financial Planning* (July 2005).
5. Private placement variable annuity investment accounts and private placement variable universal life investment accounts are only available to accredited investors (Securities Act of 1933 Section 2(a)(15)(i) and Section 501 of Securities and Exchange Commission Regulation D) or qualified purchasers (ICA Sections 2(a)(51), 3(c)(1) and 3(c)(7)).

Accredited Investor:

- A natural person with individual income of more than \$200,000 per year, or a joint income of \$300,000, in each of the last two years and is reasonably expected to maintain the same level of income.
- Natural person with a net worth exceeding \$1 million, either individually or jointly with his spouse.
- Entity/trust with total assets of more than \$5 million.
- Entity in which all of the equity owners are accredited investors.

Qualified Purchaser:

- Natural person who beneficially owns not less than \$5 million in investments.
- A family-owned company or trust with at least \$5 million in investments.
- Trust in which the investment trustee is a qualified purchaser.
- Entity owns not less than \$25 million in investments.
- Entity in which all beneficial owners are qualified purchasers.

6. ICA Section 3(c)(1) and Section 3(c)(7).

7. *Webber v. Commissioner*, 144 T.C. No. 17 (June 30, 2015).

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