SOCIETY OF ACTUARIES

Article from

Product Matters!

August 2020

SOCIETY OF ACTUARIES
PRODUCT DEVELOPMENT SECTION

PRODUCT MATTERS!
AUGUST 2020

Managing Mortality Costs Within COLI/BOLI Programs

By Matthew B. Schoen and James P. Van Etten

Editor's note: This article originally appeared, with minor differences, as the second article in a series on corporate-owned and bank-owned life insurance (COLI/BOLI) programs. Part 1, "Effects of Experience Rating on COLI/BOLI Programs," can be found in the June 2020 issue of Product Matters!

This article is designed from the point of view of the purchaser of corporate-owned life insurance (COLI) and bank-owned life insurance (BOLI) policies to:

- provide guidance regarding when experience-rated designs are more suitable than other designs (and vice versa) and
- enumerate some strategies for minimizing exposures to excessive mortality-related costs.

In our previous article we described differences between experience-rated and non-experience-rated designs, explained why the purchaser of COLI/BOLI products has an exposure to the risk of excessive mortality costs and tried to quantify this exposure.

One troubling fact about this exposure is that, like locusts, it can lie dormant for years, even decades, before surfacing to wreak havoc. Given that most COLI/BOLI plans have half-lives extending more than 25 years, seemingly benign inexpression during early years can conceal the 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 Those carriers no longer subject to competitive demands (i.e., those that have withdrawn from the market) are far more likely to exhibit unwelcome behavior.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 them less constrained by client loyalty and therefore more prone to pursue increased profitability.

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 cost of insurance (COI) 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 policyowners and have remained at the lower level for over eight 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.

In December 2013 Company X announced to its clients and brokers that it would be increasing COIs beginning in early 2014.[1] 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, which we'll call Company Y, informed its BOLI policyowners 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.[2]

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…[3]

Note the requirement that changes be applied on a uniform basis does provide some protection to policyowners (i.e., it suggests

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

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 five 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 that predicts further decreases. Of course, Company Y could elect to extend the period of the increase, but in theory at least, all policyowners 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.[4]

Considering the generous discretion retained by each carrier over setting COI rates, it is difficult to lay all of the responsibility with them. Policyowners and their advisers could have secured better contractual terms (and better outcomes).

By raising COIs, Company X and Company Y have become industry outliers; unfortunately for most general account (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 *Best's Key Rating Guide*)[5] and the 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, Figure 1, excerpted 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 earlier, appears to be temporary.

When viewing Figure 1, 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 figure 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.

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 percent to 2.5 percent). 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.

APPROACHES TO MINIMIZE EXCESSIVE MORTALITY COSTS

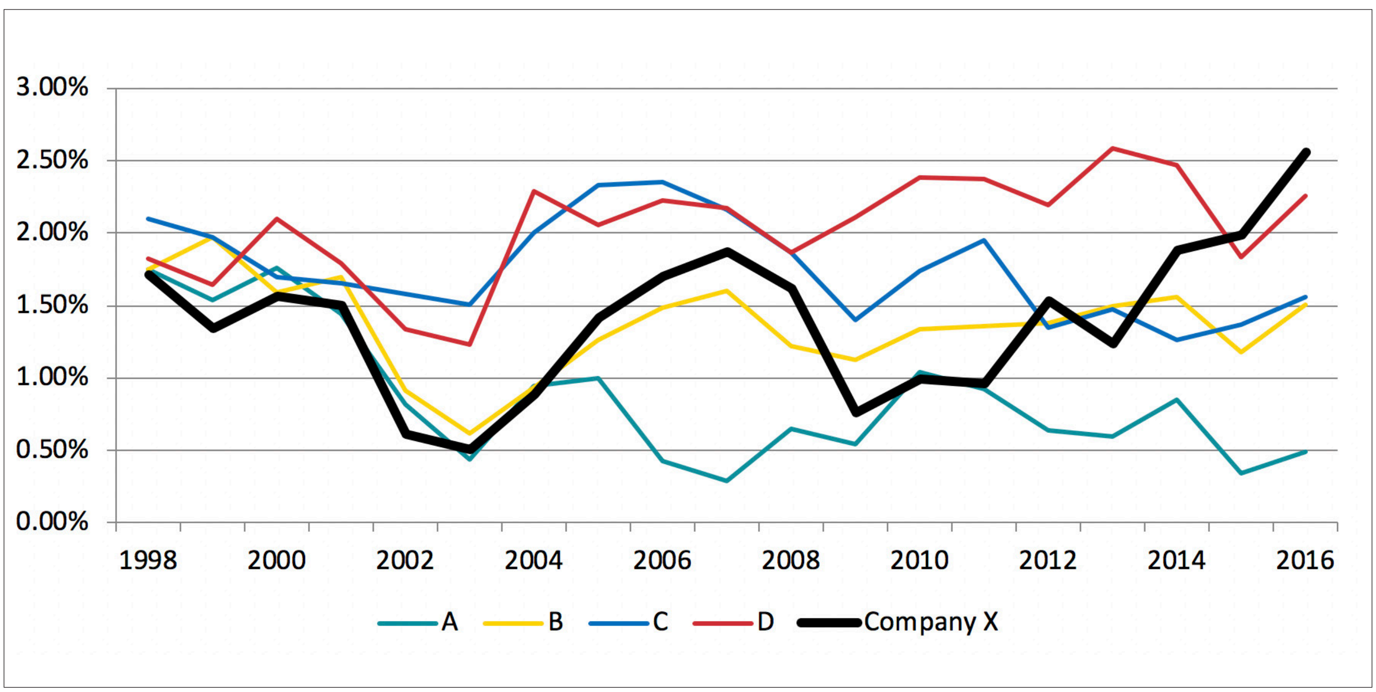
By now it likely appears obvious that the authors strongly favor policy purchasers securing experience-rated mortality designs whenever facts and circumstances permit (subject to the other considerations discussed, including size and demographic composition of insured population, and risk transfer).

But it bears stating that experience rating in and of itself doesn't eliminate exposure to excessive COI costs. Even with experience rating there are approaches that provide at least some exposure to unanticipated costs.

As Table 1 in our previous article shows, 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

Figure 1
Spread Between Annual Carrier Net Yield and Net Return on Assets on Policy Cash Surrender Value



Source: MB Schoen & Associates.

on changes to mortality experience and expectations of future mortality experience.

There are many ways to achieve this. Unambiguous language within the policy is an ideal starting point. However, seemingly unambiguous policy terms may not always be sufficient. Consider the 2012 lawsuit Norem v. Lincoln Benefit Life.[6] 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."[7]

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.

The district court granted summary judgment 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.[8]

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. 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 too many policies.[9]

It is also advisable to obtain, prior to purchase, a full and authenticated copy of the policy filing applicable to one's 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 determination procedures, it is possible the carrier has alternative documentation on these procedures. These determination procedures will reveal whether the carrier has retained the right to increase COIs 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 Sept. 5, 2017, New York promulgated Insurance Regulation 210.[10] This regulation:

> establishes standards for the determination and readjustment of nonguaranteed 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 nonguaranteed 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.

Regulation 210 was effective as of March 19, 2018. It does apply to future changes in nonguaranteed 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 nonguaranteed elements for COLI and BOLI plans (it appears the industry succeeded in lobbying for a specific exemption).

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.[11] 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.)

California approved a statute on Sept. 19, 2018, that requires notice of adverse changes in non-guaranteed elements.[12] We are not aware of any effective regulation of changes in non-guaranteed elements, including COI 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. Although the regulation is not directly applicable to COLI/BOLI plans, it is possible that some carriers will consider the requirements when changing non-guaranteed elements on COLI/BOLI products. It provides an excellent framework for buyers to avoid being gouged by carriers, while granting the insurer a defensible degree of latitude in adjusting non-guaranteed elements over the life of a policy.

The articles in this series were designed to provide institutional purchasers and sponsors of life insurance with knowledge about the mortality costs, benefits and risks associated with COLI/BOLI programs. Articles in the original series that are not expected to appear in Product Matters! *include "Risk Transfer Considerations," which addresses these considerations from a variety of perspectives, and "Common COLI/BOLI Misconceptions," which concludes with a discussion that debunks common misconceptions that have been used to criticize the purchase of COLI/BOLI programs. The interested reader can find the entire series at www.mbschoen.com under News and Publications (dated March 1, 2019) in the Resources tab.*

Matthew B. Schoen is founder and president of MB Schoen & Associates, Inc. (MBSA) and founding principal of Private Placement Insurance Products, LLC (a FINRA B/D), Concept Hedging, LLC and DC Plan Insurance Solutions, LLC. He can be reached at *mbschoen@coliaudit.com.*

James P. Van Etten, FSA, MAAA, is managing partner of Van Etten Actuarial Services, LLC. He can be reached at *vanetten.jim@gmail.com.*

ENDNOTES

1 Company X's COI rate increase was announced in a Dec. 9, 2013, letter from the company's chief operating officer and relationship manager within the Company X COLI/BOLI service center.

2 Company Y's COI rate increase was announced in a March 15, 2016, letter from an affiliate of Company Y.

3 Policy Form 94-310 (originally issued by an affiliate of Company Y and assumed by Company Y).

4 Policy Form 1-11811199.

5 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.

6 Norem v. Lincoln Benefit Life Co., No. 12-1816 (7th Cir. 2013).

7 Universal life policies contain a table of guaranteed maximum cost of insurance rates. Evidently, the table contained in this policy is on page 5.

8 Supra note 6.

9 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 policyowner tax purposes.

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

11 The language of the regulation states, "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."

12 California Assembly Bill 2634 added Section 10113.70 to the Insurance Code. This bill requires notice to policyowners as well as additional information for any adverse change in the current scale of non-guaranteed elements that is scheduled to take effect on or after July 1, 2019. The bill requires an explanation that the adverse change is "based on the future cost of providing the benefits under the policy." Section 10113.70 does not incorporate the same requirements as New York, namely that "adjustments made to existing policies to be based on expectations as to future experience and not made in order to recoup past losses."