

M INTELLIGENCE

ASSESSING CARRIER FINANCIAL STRENGTH DUE CARE FOR NON-INSURANCE PROFESSIONALS

When your clients buy tens or even hundreds of millions of dollars of life insurance, they may be required to purchase the coverage from more than one life insurance carrier. As a professional advisor, your client may rely on you to understand, provide comfort, and possibly even opine upon their decisions to purchase life insurance.

A life insurance contract is simply a long duration promise to pay a death benefit. Whether your client buys a single policy or multiple policies, understanding how to evaluate the financial strength of a life insurance carrier matters. At M Financial, we call this due care.

Due care requires mastery of specialized insurance jargon, high level accounting, and actuarial and financial acumen. Average life insurance advisors and buyers are not typically equipped with the technical insight and resources to perform independent due care and assess life insurance carrier financial strength.

IT BOILS DOWN TO MANAGING RISK

Life insurance claims are almost always paid as contractually agreed. Although rare compared to other industries, life insurance carriers occasionally do become “impaired” and “fail.”¹

Impairment is a term of art

A carrier is impaired when it’s placed into conservation or rehabilitation, or is liquidated due to insolvency.

STATE REGULATORS ASSESS LIFE INSURANCE CARRIER STRENGTH

In the United States, life insurance carriers are regulated at the state level. Largely uniform, state regulations ensure consumer protection and provide a framework for setting reserve and capital requirements. These same regulations dictate policy terms and reporting requirements, and grant the regulatory authority for the state to take control of a carrier when financial impairment occurs.

Conservative Reserving and Surplus Capital Back the Ability to Pay Claims

Regulations require life insurance carriers to hold reserves sufficient to cover all future claim costs. In addition to reserves, life insurers are required to hold surplus. Conservative assumptions for expenses and interest earnings also provide for additional reserve cushion.²

¹ According to A.M. Best, insurance carrier impairments have been relatively low for over a decade despite the 2008 financial crisis. The average impairment rate for the past 10 years has been 0.15% (15/1000ths). A.M. Best attributes this low impairment rate to the improved financial condition of insurers and regulatory actions. (Due Care Bulletin, Nov. 2012, Data Source AM Best); (A.M. Best, Best’s Impairment Rate and Rating Transition Study — 1977 to 2019; June 15, 2020)

² Who’s Watching Your Back? An Assessment of Life Insurance Policyholder Protection Following the Passage of the Budget Control Act of 2011. Prepared and researched by M Financial Group, Aug. 2011.

RATING AGENCY REPORTS PROVIDE AN X-RAY INTO A CARRIER'S HEALTH

Rating agencies provide commentary and opinions about firms' abilities to meet their obligations.³ Several rating agencies offer opinions about life insurer financial strength and the ability to meet ongoing policyholder obligations. Rating agencies are not infallible but are consistent and thorough in assessing insurers' financial conditions.

Rating Agencies

Four major rating agencies offer opinions about the financial strength of life insurance carriers and are designated by the Securities and Exchange Commission as Nationally Recognized Statistical Rating Organizations (NRSROs).

SIZE MATTERS: THE IMPACT OF LARGE LIFE INSURANCE CARRIER CAPITALIZATION

Over the past 25 years a few life insurance carriers have required regulatory intervention or become insolvent. The vast majority were small carriers with under \$20 million of surplus.

Carriers with surpluses below \$20 million are over 50 times more likely to fail than carriers with surpluses in excess of \$500 million.⁴ This difference in failure risk can be traced to diversification. Smaller carriers are less able to diversify their assets and business lines,

leaving them more vulnerable to scale risk, asset quality deterioration, issues arising from mispriced policies, and higher-than-expected claim experience.

Carrier Public Financial Information Can Provide Excellent Background Into Size and Scale

Public information can provide insight into the life insurer's financial condition, such as:

Surplus: The difference between a carrier's assets and their liabilities, surplus provides additional resources above and beyond the reserves held by the carrier to meet policyholder obligations.

Invested Asset Allocation: Most life insurers invest the bulk of their assets in fixed income securities such as bonds, commercial mortgages, and mortgage-backed securities. These long-term investments are a good match for long-term liabilities like life insurance.

Bond Quality: Insurers are required to report the quality of their bond holdings by a regulatory class definition system. Generally, life insurer bonds are predominantly considered "investment grade."

Risk-Based Capital (RBC) Ratio: RBC is a regulatory method of measuring the minimum amount of capital appropriate for a life insurer to support its overall business operations in consideration of its size and risk profile. RBC regulations require a carrier with a higher amount of risk to hold a higher amount of capital to maintain its RBC ratio.

RATING AGENCIES	
A.M. Best Rating Services, Inc.	Moody's Investors Service, Inc.
A++, A+, A, A-, B++, B+, B, B-, C++, C+, C, C-, D, E, F, S	Aaa, Aa1, Aa2, Aa3, A1, A2, A3, Baa1, Baa2, Baa3, Ba1, Ba2, Ba3, B1, B2, B3, Caa1, Caa2, Caa3, Ca, C
Fitch Ratings, Inc.	S&P Global Ratings
AAA, AA+, AA, AA-, A+, A, A-, BBB+, BBB, BBB-, BB+, BB, BB-, B+, B, B-, CCC+, CCC, CCC-, CC, C, RD, D	AAA, AA+, AA, AA-, A+, A, A-, BBB+, BBB, BBB-, BB+, BB, BB-, B+, B, B-, CCC+, CCC, CCC-, CC, C, D

³ Rating agencies are often paid by a carrier or carriers to assess their financial strength. While a good indicator of liquidity and strength, some rating assessments are focused on the carrier from an investor standpoint, while others stress claims-paying ability.

⁴ A.M. Best, Best's Impairment Rate and Rating Transition Study — 1977 to 2019; June 15, 2020.

WHAT IF

WHAT IF A CARRIER FAILS?

If the surplus of a carrier falls below a minimum required level, the state regulator is required to intervene and take specific actions to protect policyholders. The most severe of these actions is to put the carrier into receivership. Once in receivership, the state insurance commissioner appoints a conservator to administer the insurance carrier. The conservator has three options:

1. Restructure the carrier with the goal of managing the carrier back to financial health and allowing the carrier to continue as an ongoing entity.
2. Sell the whole carrier.
3. Liquidate the carrier by selling its parts.

In any case, all policy guarantees usually remain in place when policies are transferred to a new carrier. But, in the extremely rare circumstance of funds on hand being insufficient to pay policyholder benefits, limited funds can be secured through the state guaranty association. In recent insolvencies, more than 90% of policyholder benefits have been covered in full.

WHAT IF A CARRIER HAS A HIGH COMDEX SCORE?

Comdex Numbers Don't Tell the Whole Story

Comparing one company's Comdex score to another may be useful in evaluating each company's relative financial strength. However, the score itself is not useful in assessing a company's objective financial strength without having the context of the objective financial strength of every other company included in Comdex.

The Comdex number itself is not a rating, but is a composite score of all of the ratings the company has received. The composite values are linked to a scale of 1 to 100 in relation to similarly situated companies.

DUE CARE AT M FINANCIAL

We do due care for you. For over 30 years, M Financial has watched over the life insurance industry, providing our community with insights and resources to help clients feel comfortable with the carriers insuring their lives. From detailed life insurance carrier rating reports to industry analyses and other detailed financial information, your M Financial advisor has a wealth of resources to provide perspective and context on the condition of the industry and individual life insurance carriers.

Reinsurance — A Backstop for Carrier Claims

Reinsurance diversifies mortality risk across numerous financially-strong, secondary parties. While a life insurance carrier maintains reserves adequate to pay claims, most life insurance carriers do not actually keep all of the risk for the lives they insure. To help transfer risk, the life insurer will “cede” some of the insured’s risk to a reinsurer who agrees to backstop the insurance carrier up to the amount of the reinsurer’s part of the claim. Reinsurers are large financial institutions who are specially tuned into evaluating these risks and are themselves highly solvent carriers.

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