Assessing Your Life Insurer's Financial Performance

When evaluating most investments, either initially or periodically, smart investors use financial statements, conduct credible analysis and seek genuine expertise.

Cash-value life insurance (e.g., whole life, universal life, etc.) can be a terrific product, providing both financial security and attractive investment returns. However, when it comes to the life insurance industry's products, finding reliable information, analysis and expertise (not to overlook mentioning quality policies) can be more than just a little bit difficult. Typically, those who are buying or renewing a cash-value life insurance policy use policy illustrations as well as financial ratings agency rankings and summaries. Unfortunately, not only do those approaches create serious problems, but the problems are seldom recognized or understood.

First, a few facts about policy illustrations and their widespread misuse. More than 20 years ago, the Society of Actuaries recommended that the following warning appear across the top of all policy illustrations: "Sales illustrations [as well as illustrations for in-force policies] should not be used for comparative policy performance purposes." Policy illustrations are not financial projections upon which anyone ought to rely. Contrary to many advisers' and clients' presumptions, illustrations are not required to be financially sustainable. Unfortunately, many draw erroneous conclusions following, for instance, pseudo-analytical reviews in which policies are compared based on rates of return on illustrated cash values and death benefits. Apparently, they have forgotten that "garbage in equals garbage out." News of many policyholders' alarm with life insurers raising costs of insurance (COI) charges provides fresh evidence of the widespread misplaced reliance and pseudo-analysis that is still being done using policy illustrations.

The value a policyholder receives from a cash-value life insurance policy—aside from peace of mind and the benefits paid to the beneficiaries of those who die prematurely—depends ultimately upon the financial performance of the insurer and the quality of the particular policy sold to the policyholder. (Almost all life insurers' product lines contain policies of drastically different quality, cost and value.) These facts are true even for guaranteed no-lapse policies, given that a guarantee is only as good as the guarantor. While the final assessment of the competitiveness of a policy is an empirical matter that is determined over time, no one should fail to understand that such a favorable future determination is obtained by achieving competitive value year after year.

Questions to Ask

To see whether you or someone advising you understands how to find quality products or to evaluate an existing policy, assess your or their knowledge of life insurers' current financial performance. Consider asking basic questions such as the following:

1. What is the insurer's rate of return earned on its relevant investments and credited on its policies?
2. How cost-effective and productive are the life insurer's home office and your agent?
3. Of the insurer's pool of insureds' coverage, what share was underwritten in the past five years, and what share remains on the books even 10 years after being issued?
4. How competitive are the insurer's average mortality costs, and what are the implications of uncompetitive costs for you?
5. How fairly does the insurer distribute its earnings?
6. What is the insurer's approach to managing its capital?

An Example of an Insurer's Financial Statements

Answers to these and many other important questions can be obtained by focusing on an insurer's data regarding its individual life insurance product line contained in its financial statements—called the Blue Book—filed annually with state insurance regulators. Figures 1, 2 and 3 show data for Knights of Columbus, a $20 billion fraternal life insurer.

Modified Income Statement

Figure 1 is a modified income statement; all investment-related aspects are contained in Figure 2. Total premiums for Knights' individual life insurance product line include premiums collected (including even those paid to reinsurers) and exclude dividends (which, when left as paid-up additions, are counted as premiums in the industry's statutory forms). Actual annual claim costs have been calculated as the difference between death benefits paid and reserves released on death. Home office expenses, sales commissions and reinsurance costs are plainly listed (the last is not nearly as significant for Knights as for many other life insurers). Lines 12A and 12B show the range in the amount of premium dollars Knights could have applied to increase policyholders' cash values. The maximum figure arises if Knights used none of the amount by which premiums exceed expenses for its own profits. The minimum arises if all of Knights' profits on this product line came from premiums.

Figure 1. Knights of Columbus Modified Income Statement (Numbers in 000s)

	2011	2010	2009	2008	4 Year Totals (2008-2011)
1 Premiums	816,424	751,366	679,192	653,649	2,900,631
2 Plus Aggregate Write-Ins	14	8	19	20	61
3 Equals: Total Net Premium + Non-Investment Income	816,438	751,374	679,211	653,669	2,900,692
4 Mortality Claim Costs	140,074	129,065	127,282	117,451	513,872
5 Reinsurance Costs	1,201	1,038	960	890	4,089
6 Agent Commissions, etc.	86,261	79,954	72,058	73,433	311,706
7 Home Office Expenses	101,064	86,758	90,613	80,383	358,818
8 Premium Taxes and Fees	10,686	8,336	7,979	8,043	35,044
9 Federal Taxes (excluding taxes on capital gains)	0	0	0	0	0
10 Misc. Benefits & Operating Costs	11,418	10,604	11,675	12,457	46,154
11 Total Expenses & Taxes	350,704	315,755	310,567	292,657	1,269,683
12A Max Available to Grow Reserves (line 3 - line 11)	465,734	435,619	368,644	361,012	1,631,009
12B Min Available to Grow Reserves (12A less profit on prod line)	379,473	322,863	249,376	223,648	1,175,360
13 Half of Product Line Profit	43,131	56,378	59,634	68,682	227,825
14 And as a Percent of Premiums	5.3%	7.5%	8.8%	10.5%	8.0%

This modified income statement shows that the business of individual life insurance is actually relatively straightforward. The costs of the primary components of a cash-value life insurance policy are clearly summarized and readily available for further analysis. The product line's annual contributions to Knights' profits, assuming half of such profits are obtained from premiums, are shown in Line 13. This facilitates the calculation of the possible premium charge that Knights imposes on its policyholders to build its capital. Knights, like mutual insurers, does not raise capital from stockholders, and therefore must raise its capital from its policyholders. This is an important fact that many who tout mutual insurers routinely fail to address.

Specific measures of Knights' cost effectiveness can be calculated when Figure 1 figures are combined with other financial statement data (i.e., the number of policies, the total amount of insurance in force) or when they are further analyzed, such as when premiums and sales costs are disaggregated into the first year versus renewals. For instance, Knights' home office expenses on average cost each policyholder about $55 per year, a cost that anyone who is knowledgeable about the industry would recognize as very low and attractive. Knights' average annual mortality costs are approximately $1,980 per million dollars of coverage, which, of course, is not to imply that every policyholder each year directly bears such cost. Delving into the premium and sales costs data, we learn that Knights pays its agents 95% of its policyholders' first-year premiums and approximately 4.7% of all single and renewal premiums. (This fraternal insurer's compensation to its agents may give new meaning to being part of the brotherhood—that is, the brotherhood of Knights agents!) While these analytical results ought to only be used properly—that is, used with knowledge of industry norms and the calculation's own limitations—these facts spotlight subjects every prospective and current policyholder needs and deserves to know.

Investment and Capital

The top lines of Figure 2 summarize Knights' total investment earnings. The portion of these annual investment earnings, after investment management expenses, distributed to the individual life insurance product line (amounts distributed to all of its other product lines have been omitted from this presentation because of our chosen focus) range between the amounts shown in lines 9A and 9B. Also shown is the absolute growth in Knights' capital/surplus over each of the four years shown, which amounts to a paltry compounded annual return of 0.12%. Consequently, we also see that—on average—throughout the four-year period of 2008 through 2011 (this period having been chosen to show an aspect of life insurance company operations noted below), Knights earned 5.23%, incurred investment management costs of approximately 13 basis points (0.13%), and yet on average credited policyholders with investment returns of approximately 6.54% (Line 10 minus Line 11), even after having deducted a 68 basis points (0.68%) capital charge for profits.

Figure 2. Knights of Columbus Investment and Capital Information

	2011	2010	2009	2008	4-Year Totals (2008-2011)
1 Gross Investment Income Less Depreciation	901,185	865,488	816,501	800,946	3,384,120
2 Realized Capital Gains/Losses Net of Taxes to IMR*	55,168	17,764	(42,679)	(120,993)	-90,740
3 Unrealized Capital Gains/Losses Net of Taxes	(44,717)	66,657	101,909	(282,058)	-158,209
4 Amortization of IMR*	23,632	14,466	14,285	12,253	64,636
5 Less Interest Expense	-	-	-	-	0
6 Total Investment Income	935,268	964,375	890,016	410,148	3,199,807
7 Average Rate of Return on Managed Investments**	5.57%	6.23%	6.27%	2.86%	5.23%
8A Investment Management Expenses and Misc. Investment Taxes, Etc.	22,875	18,529	16,840	19,788	78,032
8B Investment Management Costs in Basis Points	14	12	12	15	13
Investment Income - Distributed to Individual Life Insurance Product Line					
9A Maximum Possible Amount to Individual Life Insurance	635,212	617,441	596,234	586,111	2,434,998
9B Minimum Possible Amount to Individual Life Insurance	548,951	504,685	476,966	448,747	1,979,349
10 Max Avg Rate of Return on Non-Borrowed Life Reserves	6.79%	7.09%	7.35%	7.65%	7.22%
11 Percentage Partitioned for Capital If Half Profits Recovered From Inv Earnings - 4-Yr Avg					-0.68%
12 Change in Capital Across All Product Lines	4,200	168,879	101,463	(303,021)	-28,479
13 Total Capital	1,921,644	1,917,444	1,748,565	1,647,102	7,234,755
14 Rate of Return on Capital - Average Annual Over Four Years	0.22%	9.66%	6.16%	-15.54%	0.12%

**Interest Maintenance Reserve: Recognized capital gains are put into IMR to be amortized over several years rather than in the current year.*
***Excludes loans to policyholders.*

No doubt, given the steady multi-year decline in the returns on bonds—which comprise over 90% of Knights' investment portfolio—its current investments returns are lower. Admittedly, to fully understand and assess the attractiveness of Knights' or any other life insurer's investment returns, much additional information is necessary; for example, facts about the portfolio's composition, average duration, its riskiness, its competitive benchmarks, etc. There can, however, be no denying the usefulness of this information. For instance, such facts no doubt surprise some who have always thought life insurers aren’t, or can’t be, attractive investment managers.

Reconciliation of Obligations to Policyholders

Figure 3 shows how Knights’ obligations to its individual life insurance policyholders changed each year. The amounts of the inflows from premiums and investments, less the total product line’s profits—retained to grow its capital, thereby preserving its financial strength—are shown in Lines 4-6. Next, in Lines 8-10, the primary payments made to policyholders are shown: the amount of dividends policyholders received in cash, the reserves paid out upon death claims and the reserves paid out upon policy surrenders. While life insurers sometimes make adjustments between their policyholder liabilities and their capital that could also have to be recorded, Knights seldom does. Its total year-end obligations to its life policyholders are listed in Lines 13-15. Any errors in reconciling Knights’ policyholder liabilities per its financial statements and its liabilities calculated via this format are shown in Line 16, their insignificance thereby providing additional verification of the validity of this analytical format.

Figure 3. Knights of Columbus Reconciliation of Obligations to Policyholders

	2011	2010	2009	2008		Beginning, Ending or Totals
1 Life Insurance Reserves Beginning of Year	9,486,827	8,851,220	8,206,352	7,855,077		7,855,077
2 Total Dividends Owed to Policyholders (beginning of the year)	343,317	324,194	309,959	370,637		370,637
3 Liabilities to Policyholders	9,830,144	9,175,414	8,516,311	8,225,714		8,225,714
						4-Yr Cumulative
4 Maximum Available from Premiums to Grow Reserves	465,734	435,619	368,644	361,012		1,631,009
5 Maximum Available from Investments to Grow Life Reserves	635,212	617,441	596,234	586,111		2,434,998
6 Less Product Line Profit Transferred to Capital	86,261	112,756	119,268	137,364		455,649
7 Interim Liab to Policyholders + Net Avail Premiums + Inv Earnings	10,844,829	10,115,718	9,361,921	9,035,473		11,836,072
8 Dividends Paid and Taken Out of the Company	74,355	71,323	70,150	75,772		291,600
9 Reserves Released to Pay Death Claims	139,510	124,578	115,770	105,061		484,919
10 Surrender Benefits	153,745	140,874	140,124	123,486		558,229
11 Reserves Released for Disability Rider Benefits	7,509	6,908	6,425	6,563		27,405
12 Total Reserves and Dividends Paid to Policyholders	375,119	343,683	332,469	310,882		1,362,153
13 Total Liabilities to Policyholders (end of year)	10,437,832	9,830,144	9,175,414	8,516,311		10,437,832
14 Total Dividends Owed to Policyholders (end of year)	355,234	343,317	324,194	309,959		355,234
15 Life Insurance Reserves (end of year)	10,082,598	9,486,827	8,851,220	8,206,352		10,082,598
16 Amount "Liabilities" Line 13 Exceed "Calculated Liabilites*"	-82,548	58,109	145,962	-208,280	4-Yr Cumulative Error	-86,757
					Model's Average Annual Error	-0.09%

**Calculated Liabilities = lines 3 + 4 + 5 - 6 + 12 (figures for 2011 omit $50,670 capital transfer).*

Source: Analysis of annual statement data by Breadwinners' Insurance.

Summary

Figures 1, 2 and 3 spotlight the critical factors affecting the financial performance of a life insurer and its cash-value policies. Facts about Knights' costs for the six primary components of a cash value life insurance policy (sales, claims, home office administration, investment management expenses, premium taxes and capital charges) are presented. This clarity leads naturally to further follow-up questions about these components actual costs in any specific policy. Similarly, insight is gained regarding the insurer's investment performance and the manner in which it shares this with its policyholders. For instance, in 2008 when Knights suffered losses on its investments (like most investors that year), the analysis shows how it used its capital to smooth out financial returns for its policyholders. Indeed, throughout all four years, Knights was actually subsidizing the returns provided to its policyholders by not growing its capital. The management of a life insurer's capital is truly a vital subject that every cash-value policyholder ought to understand, but one that virtually none learn anything about from their agents or other financial advisers.

This introductory presentation shows just some of the many insights that can be gained from understanding the financial performance of life insurers. While ignorance or wishful thinking can often seem blissful, everyone eventually realizes just how terribly costly they really are.

Given that few, if any, policyholders (and even few other marketplace participants) ever obtain or use real relevant financial information and expert financial analysis of policies, it ought not surprise anyone that cash-value life insurance as an investment is so seriously misunderstood and widely disparaged. While in theory, the product has several very valuable characteristics and tax privileges, in practice consumers are almost always sold (and often keep) policies that no informed consumer would ever want.

Yet, for those who obtain good information and genuine analytical expertise, tremendous value can be readily obtained.

This post was adpated from Brian Fechtel's article in the April 2016 issue of the AAII Journal. For the unabridged version, click here.