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At Witt's End

Life Insurance in the Financial Crisis - Solvency Follow-Up
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Our recent newsletter regarding the safety of life insurance companies generated a number of follow-up questions, and we hope that our responses may be beneficial to you or your clients.

Q: How common are life insurance company insolvencies?

A: Probably a lot more common than you realize. In the last 25 years, there have been more than 250 life insurance companies that have become insolvent, and many of those cases resulted in the sale or transfer of blocks of business to other companies.

More than 75% of the insolvencies have involved life insurance companies that did business in 3 or fewer states. If we use a threshold of being licensed in 30+ states as a proxy for companies with a national reach, then there have been roughly 30 insolvencies in the last 25 years that meet that definition.

To put the number of insolvencies in context, there are currently about 1,000 life insurance companies in the United States--down from about 2,300 companies in the late 1980s due primarily to consolidations and mergers.

At an aggregate level, that translates into an annual insolvency rate somewhere between 1% and 2%. That is, without even taking into account the recent economic crisis, historical averages suggest that perhaps 10-20 life insurance companies will become insolvent each year.

Q: What are the most common causes of insolvency?

A: There are many. Some are caused on the asset side, such as an implosion in an overly concentrated investment position such as junk bonds or real estate. And some are caused on the liability side, such as insufficient reserving for guaranteed product features.

Still other possibilities are inadequate pricing, too-rapid growth (since new business causes an initial hit to surplus), and relationships with affiliates that can be financially damaging.

Q: What are some companies I may have heard of that became insolvent?

A: Here are 5 that may ring a bell, along with the year they became insolvent:

Executive Life (1991)
Fidelity Mutual (1992)
Mutual Benefit Life (1993)
Confederation Life (1994)
Kentucky Central Life (1994)

All of these companies were licensed to do business in all but one or two states (and in some cases every state).

Q: Do we know what policyholders may have lost in these 250+ insolvencies?

A: In our last newsletter, we indicated that we were not aware of guarantees being breached in the history of the U.S. life insurance market. A more accurate description is that we are not aware of any beneficiaries receiving less than the guaranteed death benefit on any policy held until the death of the insured.

There have been multiple instances where "guaranteed" provisions other than death benefits have been altered in the course of an insolvency. Be careful about relying too much on the historical precedent that has seemingly been set with respect to guaranteed death benefits in insolvencies. Guaranteed provisions on insurance policies can be altered to keep a company afloat, and there very well may come a day when guaranteed death benefits will be altered as well. (And recall that policies in excess of the state guaranty association limits - often $300,000 per insured life - have nothing backing the guarantee other than the assets of the company.)

Q: Are guarantees the only thing I need to worry about with regard to insolvency?

A: No. A high percentage of cash value policies derive the bulk of their long-term value from non-guaranteed elements based largely on the investment performance and mortality experience of the insurance company. In short, if consumers better understood the life insurance marketplace, they would realize that in many situations the guarantees across various policy options are nearly identical and the non-guaranteed elements are the only thing that differentiate one policy from another.

Policyholders have legitimate reason to be concerned about the performance of their non-guaranteed policy after an insolvency. In all likelihood, those policies suffered a dramatic downturn in performance leading up to the insolvency, because a company will generally do anything possible to avoid an insolvency, and non-guaranteed elements are an easy target. Furthermore, after these policies are transferred or sold to another company, it is difficult to predict how they will perform. Our educated guess is that they will generally perform better than they would have had the troubled company continued to manage them, but generally will perform worse than what the company would have delivered had it never encountered trouble.

Even if the guarantees on your policy are not breached or you technically do not "lose" anything because of the support of a state guaranty association, recognize that there are many types of policies that could still be significantly damaged by an insolvency or the threat of insolvency.

Most people have a strong negative reaction to the idea of their insurance company becoming insolvent. And while we wholeheartedly agree that you would never want to willingly own a policy from a company that becomes insolvent, we also caution that you need to make a well-informed decision if your company is in the midst of an insolvency or if you are abandoning your current company out of concern over future solvency.

The best remedy (which is of no value to those already insured with a company in a precarious position) is to do your homework up front, which at a minimum should include checking the financial strength ratings of companies. And while no amount of due diligence can eliminate the possibility of an insolvency, it can certainly tilt the odds in your favor.

The recent financial turmoil has caused a "flight to quality" in many arenas, and we expect life insurance consumers to become more savvy with their purchases in the near-term future with a renewed emphasis on the financial security of and the prudent management of life insurance companies.