Investment Advisor
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Saving Grace

You made sure your clients had all the right protection; then insurance became a minefield. What now?

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Tommie Monez of Focus Wealth Management in Middleburg, Virginia, is keeping an eye on current conditions in the insurance industry on behalf of two of her firm's clients. Client A, 79 years old, has a long-term care policy purchased long ago from Penn Treaty, currently in voluntary rehabilitation with the state of Pennsylvania. Client B has an annuity, also purchased years ago, from Shenandoah Life, currently in receivership.

Monez has to watch the situation closely, because Client A would most likely no longer be able to afford to purchase LTC coverage from another company. Monez is also concerned about protecting Client B's investment in the annuity—an investment now potentially at risk. However, fortunately for both clients, at present neither needs the product each bought in prior years: Client A is still in good health, despite her age, and Client B is in solid financial shape and is not relying on the income from the annuity.

But what about your clients and their insurance choices, whether they were made before they came to you for planning, or are currently under review? Particularly as economic and market circumstances change, you'll have to keep close tabs on what they have and what they're thinking of getting. Whether you're an agent or a fee-only advisor making recommendations, you're going to be watching a whole new set of indicators these days. If worse comes to worst, do you know what to do to protect your clients from losses due to their insurance choices?

Rules and Regulations

Fortunately, insurance companies don't operate in a vacuum. Insurance is regulated in one way or another either by state regulators, legislation, or rulings by a court that may clarify, void, or otherwise modify existing regulations.

State insurance departments are, of course, the boots-on-the-ground regulators for day-to-day business, and their commissioners all belong to the National Association of Insurance Commissioners (NAIC). These departments have the power to undertake a number of actions when an insurance company's ability to deliver products is in doubt, as the Pennsylvania Department of Insurance has done with Penn Treaty.

In that case, after a petition by the insurance commissioner, the court approved the commissioner as rehabilitator and work began to help the company recover, if possible, while honoring its commitments to policyholders.

Beyond that, many insurers are required to belong to at least one of the state guaranty associations, which provide a kind of last-resort protection should a company fail. The company must belong to the association in the state in which it is licensed. These associations function somewhat like the FDIC in that they collect funds from healthy insurers to offset policy obligations of unhealthy ones. There are several differences in how they operate, and in fact they can levy special assessments if necessary. (More about them later.)

No insurer or agent, by the way, can use the existence of a state guaranty association as an inducement to sell or promote a policy.

That's What It's For
According to Claude Thau, of Target Insurance Services in Overland Park, Kansas, insurance companies are "basically conservatively financed," and the states require that they set aside reserves "intended to be redundantly excessive." Beyond that, he adds, states also require the companies to hold a certain amount of risk-based capital. The amount reflects not only the types of policies they sell—life insurance may be more profitable than annuities and require less capital on hand, for instance, if annuitants live, and collect, for a long time—but also the types of investments they make. If companies invest in stocks rather than bonds, he explains, the higher their risk-based capital balance must be.

Currently, says Thau, the news is full of companies' risk-based capital decreasing. That's exactly how it's supposed to work, he points out, since companies can still pay claims. Just because an insurance company's capital is decreasing "does not translate to the sky is falling," he says. He adds that insurance companies are relatively safe havens in today's economic climate compared to banks and brokerages. This is because people who cash out annuities must pay surrender charges, and much of the life insurance sold is term, with no cash surrender value; thus lapsed term policies involve no cost to the insurer. The only way to cash in a long-term care policy, he points out, is to use it, so the whole benefit isn't taken at once; instead it "dribbles out."

Even impaired assets held by these companies can recover, such as investments in bonds, which currently may be undervalued. So even if companies don't look healthy in the press, due to lower valuations on assets that they hold, if they don't have to divest themselves of those assets immediately, the values may recover with time and the companies will once again have strong-looking balance sheets.

If despite all that a carrier doesn't have 100% of its mandated risk-based capital, "the state will tell you you have to cease and desist writing new business," says Thau. Such companies still pay claims, and still have a surplus, just not enough of a surplus. When a company writes new business, Thau explains, there's a strain on that surplus because of underwriting expenses and commissions. So if a company is showing signs of trouble, it will be forbidden from writing new business to decrease that strain. That doesn't necessarily mean, however, that it can't pay its claims.

What Am I Looking For?
Thau says there's plenty advisors can do to keep apprised of the health of client coverage. If a company fails, find out whether the policy is reinsured, and if so, to what degree and whether the reinsurer is healthy. If there is reinsurance, another question to ask is whether the reinsurer's money "goes into general coffers, and therefore is liable to be claimed by anyone with a claim against the company, or whether it's to reimburse the company to make the payment."

Next he suggests looking at the state's guaranty association and its limits on policies (those limits differ, depending on the type of insurance, and they also vary from state to state). The National Organization of Life and Health Insurance Guaranty Associations (www.nolhga.com), has a complete listing of association Web sites for all 50 states, as well as the District of Columbia and Puerto Rico. It also offers a wealth of information on everything from what happens when a company is in trouble to what the guaranty associations do when it's time for them to get involved.

He also reminds advisors to look beyond the headlines about reserves and stock prices. Just because a company's reserve is falling, or its stock price is getting pummeled, it does not necessarily mean, again, that the company does not have enough reserves to pay its claims. It may simply mean that its profits are decreasing. "It's really important to differentiate the issue of profit from the ability to pay claims," he says, pointing out that companies are required to invest, even though currently some of those investments are in question. Under those circumstances, a company's profitability will fall because it cannot take reserves from its subsidiary companies, because the states have locked up those funds "for claim purposes." As mentioned previously, it must put up additional reserves, which affects its profitability but not its ability to pay claims. While an advisor should track any company about which she has concerns, she may not have to do anything else unless the situation worsens.

Another factor to consider is the variable annuity. Companies that sold VAs may also be carrying a lot of exposure because of clauses that promised to pay the maximum value of the policy as a death benefit. "So when those assets drop down all of a sudden, there's a lot of death benefit exposure," Thau explains. "Your assets were worth $500,000 and now they're only worth $300,000, and the insurance company only has $300,000 worth of assets but has to pay you $500,000." That's a lot of reserves, he adds, pointing out that insurers have to put up the money to cover that, and that's "killing their earnings – but if [annuitants] don't die right away, the assets will build back up and be released back into earnings."

Watch Out for the Fine Print
Thau reminds advisors that companies also have other options open to them that the advisor must keep in mind while assessing his clients' overall financial situation. These include changing the terms of contracts—raising rates for a class of insureds, for instance, which can be problematic for clients with long-term care policies; lowering the interest rate on annuities; or increasing monthly deductions on the amount at risk on universal life policies.

Any of these can cause headaches for clients, depending on their situations, and particularly elderly clients or those in ill health who may not qualify for other coverage if their LTC premiums increase substantially. These may be forced to opt for less coverage, or adopt other strategies, to be able to afford to keep their policies.

Clients wishing to pull out their funds from annuities will have to watch out for surrender charges, or delays in withdrawal of funds, particularly if the company is in serious trouble. Of course, any time an individual simply drops a policy from a company in trouble, it lessens the obligation of that company to pay and thus relieves the pressure on its reserves just a bit and making it a little easier on the remaining insureds.

One very important thing to remember: Advisors must make sure that unless or until new coverage is in place, clients continue to pay premiums, even if a company is in trouble, lest coverage lapse and even the last-resort guaranty association protection be lost.

Guaranty Associations Do What?
NOLHGA, founded in 1983, provides state, D.C., and Puerto Rico guaranty associations with a means to coordinate efforts to cope with insurance problems that span multiple states. It provides state associations with economies of scale in hiring experts to assist any task force formed to deal with a multistate insolvency on the part of an insurer; it ensures covered claims are paid and arranges transfer of policies to another insurer; and it can also support a receiver in maximizing the value of a company's assets as they are disposed of.

According to Bart Boles, chairman of the Members Participation Council of NOLHGA's board of directors, and executive director of the Texas Life, Accident, Health & Hospital Insurance Guaranty Association, state guaranty associations provide protection to varying degrees for life, health, LTC, disability, and annuity coverage. What's important to remember for your clients is that there is protection as long as the company is licensed in the state in which your client lives. "Licensing in the state is key for determining guaranty association coverage," he says.

If a company is liquidated, he adds, the state guaranty association is authorized to step in and provide protection to the policyholders in that state. "Say I have a Texas policyholder," he explains, "[holding] a LTC policy with a company [licensed] in Virginia and 30 other states. If the company is licensed in Texas, it will be protected."

Boles adds that the residency of the policyholder and the licensing status of the company at the time of the insolvency, not at the time of purchase of the policy, determine whether coverage is available. Coverage is also determined by the law for the guaranty association at the time of the insolvency. "That's hopeful for the consumer," he says, "because coverage has only been increased, not decreased." Currently, he points out that there are bills pending in the Texas legislature to increase coverage, and if those bills pass, any policyholders filing claims after that "will be protected at those higher levels. It depends on when the insolvency occurs."

While the limits on protection, as mentioned above, differ from state to state, there are some basic standards, Boles says. "All guaranty associations were created by individual state legislatures based on the NAIC's National Life and Health Association Model Act. Most have done some tweaking and as the Act has been updated, some [associations] have updated; some have updated pieces [of protection]." Because it's legislated state by state, it's not consistent throughout the country, but the minimum standards are "fairly consistent."

Shopping in a Risky Market
What do you do about clients who need coverage or are looking for annuities? How can you advise them wisely? Previously, Boles says that he'd always told consumers to look at the insurance company ratings by the major rating agencies. However, now that asset valuations are so low and ratings agencies are being extremely cautious, reducing ratings "extremely quickly," he's hesitant to do so. Instead, he says to monitor any type of actions taken by insurance regulators via the NAIC. Risk-based capital standards dictate how much companies must hold, and if a company falls below that level, there are several different levels of action that may be taken.

"There's a regulatory action level, then a mandatory level, where a regulator has to get involved," he explains; "it's a way to monitor if a company is running thin." Advisors monitoring these actions may see a company put into receivership or rehabilitation by a regulator, with controls enacted and certain policyholder withdrawals stopped to prevent a run on the company. Boles points out that some companies that have gone down a bit might be able to recover, but "if you have a run it could force it to go under." He also says that some actions are taken publicly and others are done confidentially.

Thomas Hampton, the District of Columbia insurance, securities, and banking commissioner, says that, in addition to monitoring a company's ratings, reading the financial statements for that company can also be very helpful.

Thau suggests relying on a combination of ratings, personal experience with the company, talking with the carrier itself, and talking with people in the industry to gauge a company's strength. If an advisor knows, for instance, about a company writing coverage "when other companies won't," maybe that carrier is not so good. "Don't always believe that something is better than nothing," he warns.

He also suggests looking at a company's Comdex ranking, which is not a rating in itself but a composite of the ratings a company has received. "It's a nice thing," he comments. "They look at the A.M. Best ranking, Moody's, Fitch, and the S&P; companies have to be ranked by at least two of them." The Comdex rating is arrived at by "which percentile ranking [a company has] by each of the organizations that ranks [it], and then average[ing] the ranking." The end result, he says, is easier to understand than other ratings; for instance, he says, Genworth (at the time of this writing) is in the 75th percentile—a bit more specific than a rating of Aa. The Comdex can also change more quickly than others, he adds; if a company's A.M. Best ranking is solid, it will increase in Comdex, where others will be dropping as their A.M. Best rankings drop.(The Comdex score is issued by EbixLife, an insurance software company, which points out that it is not a ratings agency.)

Scott Witt, of Witt Actuarial Services, LLC in New Berlin, Wisconsin, warns that advisors should be wary of changing policies for the sake of change. They must evaluate the risks of maintaining current coverage versus the potential risks of abandoning it and buying new coverage, which might be more expensive and have fewer options, perhaps because of changes in the client's age, health, or other circumstances since the original policy was purchased.

Alternate Strategies

If you're helping clients cope with a company in trouble, you'll need to evaluate all the options. Advisor Monez says that her Client B, with the annuity from the company in receivership, does not currently need the money, and is adequately protected through the guarantee association's coverage. But if she could not survive without access to the money, Monez says she'd be working to get her a hardship withdrawal. "If the annuity value exceeded the $100,000 covered by the Virginia Guaranty Association and it was a substantial part of her retirement savings," she writes, "I would have to take a hard look at her living expenses, other assets, or even employment opportunities to see if there were any options for recovery."

Client A, on the other hand, could be in serious trouble if she had to file a claim on her LTC policy. At her age, says Monez, she's too old to get coverage from another company at a reasonable price, and the guaranty association's coverage wouldn't go far if a claim stretched out. "With long-term care running around $200/day in this area, [she] could easily run through what is currently a very comfortable level of savings that she is using only for emergencies and discretionary expenses," she says. "She could run out of money in four to five years."

In that case, Monez would advise her to use her savings to continue to pay the LTC premiums, "even if they are significantly increased." She goes on to say that if her client were in a situation where those costs could not be covered, she would investigate using other options, such as home equity, or perhaps asking family members to pay the premiums. "It makes perfect sense for children to pay for their parent's long-term care insurance to protect the assets that they will eventually inherit," she says.

You may need to be creative, and you certainly must be diligent, to help your clients ride out this economic storm in safety.

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