Life Insurers' Financial Performance and The Importance to Policyholders of Understanding Such

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More than a trillion dollars is currently invested in cash-value life insurance. Tens of billions of additional dollars are received as premiums each year. Extensive state regulations of insurers have been enforced for more than a century. Tens of thousands of agents, financial advisers and others make representations about products to millions of consumers every year. Given such facts, one would think that all the relevant financial information about cash-value life insurance would be widely available and well understood. But how much do you know about such financial performance basics as life insurers' investment returns, operating costs, mortality charges, etc.?

The significance of the financial performance of one's life insurer cannot be overstated. The value that one receives from a cash-value life insurance policy depends critically upon the financial performance of the insurer, a fact most people do not fully comprehend. While some policies, such as universal life with lapse protection, can be guaranteed contracts, most cash-value life insurance policies are participating contracts. That is, the growth in policy values and the flexibility such growth provides in meeting premium obligations are dependent upon the insurer's financial performance and operating practices after the policy has been issued. In light of such, participating cash-value life insurance policies are "priced" after, not before, the consumer has purchased it.

Everyone knows that to make good recommendations or decisions require appropriate and relevant financial information. And yet, if knowledge about such performance is inadequate, then demonstrating that anything akin to the due diligence requirements of selling, buying, or renewing a policy have been fulfilled may be difficult if not impossible. To evaluate your specific knowledge and understanding of life insurers, consider the following questions.

1. What was the total rate of return on your insurer's investment portfolio over the last year? Over the past five years and ten years?

2. What is the composition of your insurer's investment portfolio? How does its risk profile measure-up with your risk preferences?

3. How much are your insurer's investment management costs? And its investment-related tax costs?

4. What are your life insurer's mortality costs? What are its costs per million dollars of coverage provided? Also, what are your insurer's reinsurance costs? How do companies that understand risk view your insurer's existing and new business?

5. What are your insurer's general operating costs? How efficiently does your insurer operate?

6. What are your insurer's sales/distribution costs for both new business and existing business?

7. What does the information on your insurer's sales growth and persistency indicate and portend?

8. What has been the rate of return on the insurer's capital? And what are the components of such?

9. How well, or to what extent, does your policy participate in your insurer's financial performance? How does its ROR on life policy reserves compare with its ROR on capital?

Answers to such questions are not currently standard parts of the life insurance policy selling, buying, and reviewing/renewing process. Typically, policy illustrations and financial strength ratings play key, primary roles in the recommendation and decision-making processes. Financial strength ratings, however, are very incomplete and narrow measurements of financial performance, hardly constituting an acceptable level of knowledge of an insurer and its policies' attractiveness/value. After all, no one ever leaves money in a bank content only knowing the existence of the FDIC guarantee. Policy illustrations, while perhaps no longer viewed with certainty, merely show one hypothetical participation performance scenario, without providing the necessary means of assessing the realism of or the assumptions inherent in such. Actuaries and other authorities have long counseled against using illustrations as comparative data or projections. Much has been written elsewhere about the limitations of ratings and illustrations. **All that now needs to be reiterated is the conclusion of life insurance authorities that neither policy illustrations nor financial strength ratings provide sufficient information for making decisions regarding the purchase or retention of a policy.**

Life insurers file Annual Statements with state regulators that summarize their financial performance over the prior year. For years, Best's, Moody's, Standard & Poor's, Weiss, and other sources have provided financial reports and ratings based on Annual Statement data. Their reports, however, have stopped short of providing answers to some of the questions above, as they have been primarily provided for the use of stockholders, not policyholders. This article presents a new approach to using Annual Statement data, and organizes such for the use of life insurance policyholders. While this new approach does not claim to completely answer all of the above and related relevant questions, it does facilitate discussions of life insurance by bringing into focus the activities and results of the life insurers. Any shortcomings of this analysis merely emphasize the need for additional research on this subject.

At the heart of understanding life insurers' financial performance is knowledge of insurers' investments, their results, and the distribution of these investment results to policyholders, bondholders/creditors, and shareholders. **Table 1** presents this analysis for a fictional insurer, Big XYZ Life Insurer, summarizing the investment returns over a recent five year period and the portion of investment returns paid in capital gains taxes and investment management costs. Policy loan interest is separated so that total returns only include earnings on managed investments, thereby adhering to the widely-used practice of direct recognition. Total rates of return on average total managed investments before and after

taxes and expenses are calculated.

Focusing upon investment returns to policyholders requires inclusion of the Amortization of the Interest Maintenance Reserve (IMR) and deduction of interest expenses in order to account for these two important factors (a source and a drain) on distributions to policyholders. In **Table 2**, distributable income is separated between that for life insurance policyholders and that for other policyholders; the former measure being further divided to reflect direct recognition practices.

Table 1 — **Big XYZ Insurer (figures in thousands)**

Years >	2000E	2000D	2000C	2000B	2000A
Investment Income	**2,940,036**	**2,763,448**	**2,459,253**	**2,334,999**	**2,166,078**
Real Capital Gains	**184,120**	**723,559**	**525,447**	**519,784**	**481,557**
Unrealized Cap, Gains	**(459,457)**	**(526,918)**	**100,155**	**(72,287)**	**282,143**
Interest Earned on Policy Loans	**313,499**	**289,991**	**271,060**	**255,892**	**240,653**
Taxes on Cap. Gains	**49,196**	**176,044**	**121,926**	**179,125**	**169,953**
Tax Effects of Unrealzd Cap Gns	**(175,734)**	**(5,660)**	**(6,187)**	**995**	**(5,736)**
Total After-Tax Inv. Earnings	**2,791,236**	**2,789,705**	**2,969,116**	**2,602,377**	**2,765,560**
Inv. Mangement Expense	**137,122**	**125,253**	**113,962**	**99,029**	**99,761**
Interest Expense	**52,528**	-	-	-	-
Amortization of IMR	**13,621**	**24,440**	**32,294**	**27,305**	**17,882**
Distributable Income	**2,615,208**	**2,688,892**	**2,887,448**	**2,530,652**	**2,683,681**
Inv. Inc. for Mngd Res. + Cap.	**2,330,198**	**2,425,619**	**2,641,604**	**2,298,716**	**2,465,721**
Inv. Inc. to Borrowed Life Res.	**285,009**	**263,273**	**245,844**	**231,936**	**217,960**
	-	-	-	-	-
Avg. Ann. Managed Investments	**35,474,488**	**33,036,262**	**30,469,793**	**27,998,099**	**25,330,231**
	5 Yr Avg.				
M'n'g'd Inv. ROR	**8.71%**	**6.63%**	**8.08%**	**9.23%**	**9.02%**	**10.62%**
Inv. Tax Costs	**0.37%**	**-0.36%**	**0.52%**	**0.38%**	**0.64%**	**0.65%**
Inv. Mgmt. Cost	**0.38%**	**0.39%**	**0.38%**	**0.37%**	**0.35%**	**0.39%**
Managed ROR - net	**7.97%**	**6.60%**	**7.19%**	**8.48%**	**8.03%**	**9.57%**

Note that, in Table 2, a portion of investment earnings are also shown being retained to increase capital (see second page of Table 2). Increases in capital arising from activities *can, of course, originate* from either earnings retained on investment income or insurance operations. In this accounting model, it is assumed that all activity-based changes in capital arise from investment activities. This assumption only slightly reduces the allocation of investment returns to individual life policies, thereby only have a minor

impact on the rate of return calculated on policy reserves, and, as explained in footnote[1], may very well be innocuous. Moreover, this framework also facilitates construction of: 1) a new, insightful Insurance Operations statement, 2) a Summary of Reserve Accounting, 3) a Degree of Participation measure.

Table 2 shows the distribution of investment returns among policyholders after returns for capital/surplus have been subtracted. Distribution to borrowed reserves, applying the practice of direct recognition, is assumed equal to interest earned on policy loans *less* a charge to account for an assumed spread between borrowing and crediting rates. (All borrowing is assumed to come from life reserves.) Average annual policy reserves and capital are presented in Table 2 so that the average annual non-borrowed or Managed Life Reserves can be calculated, as well as the annual rates of return on total life reserves and other product reserves.

Table 2 **Big XYZ Insurer (figures in thousands)**

Years >	5 Yr Avg.	2000E	2000D	2000C	2000B	2000A
Distributable Income		**2,615,208**	**2,688,892**	**2,887,448**	**2,530,652**	**2,683,681**
Individual Life		**2,273,216**	**2,002,709**	**1,908,342**	**1,836,665**	**1,654,779**
All Other Products		**289,720**	**318,806**	**223,920**	**264,317**	**291,811**
Inc. to Non-Borrr'wed Life Res'rves		**1,988,207**	**1,739,436**	**1,662,498**	**1,604,729**	**1,436,819**
Inc. to Borrowed Life Reserves		**285,009**	**263,273**	**245,844**	**231,936**	**217,960**
ROR on Non-Borr'wed Life Res. w/DirectRec'gnit'n	**8.33%**	**8.15%**	**7.82%**	**8.20%**	**8.76%**	**8.71%**
ROR on Total Life Res'rves (nonDirectRec'gnit'n)	**8.01%**	**7.90%**	**7.60%**	**7.90%**	**8.35%**	**8.28%**
ROR on Other Prod'ucts	**8.13%**	**7.75%**	**9.06%**	**6.57%**	**7.99%**	**9.31%**
Avg. Ann. Non-B'rr'wed Life Res.		**24,383,730**	**22,241,248**	**20,263,652**	**18,309,147**	**16,505,321**
Avg. Ann.PolicyLoans(Brr'wd Res.)		**4,383,040**	**4,110,496**	**3,879,341**	**3,685,576**	**3,491,218**
Avg. Ann. All Other Prod. Reserves		**3,739,752**	**3,519,452**	**3,407,741**	**3,307,935**	**3,133,398**
Avg. Ann. Capital		**4,466,669**	**4,124,570**	**3,817,383**	**3,468,923**	**2,971,847**
Total Res'rves + Cap. w/ Claim on Managed Inv. Earnings		**32,590,151**	**29,885,269**	**27,488,775**	**25,086,005**	**22,610,566**

[1] While any assumption can be challenged as being arbitrary, this assumption may be especially benign to cash-value policyholders - those, after all, who are most interested in the insurer's investment performance. If the insurance activity is viewed as a "separate, actively-managed business investment with its own profits," then this consolidating assumption can readily be seen as appropriate and justified. That is, any insurance operation profits are merely returns on the insurer's investment in such operations. Furthermore, given mutual policyholders expectation to receive insurance at cost, this assumption corresponds with at least a simplistic understanding of receiving one's insurance coverage at cost.

Table 2 continued

		Big XYZ Insurer (figures in thousands)				
		2000E	2000D	2000C	2000B	2000A
Capital Change Specifics						
Capital & Surplus (inc. AVR) b.o.y		**4,284,435**	**3,964,705**	**3,670,060**	**3,267,786**	**2,675,909**
Distribution to Capital from Inv.		**52,272**	**367,377**	**755,186**	**429,671**	**737,092**
IMR Amortization		**(13,621)**	**(24,440)**	**(32,294)**	**(27,305)**	**(17,882)**
Adjustm'nts due to Listed Changes*		**(51,249)**	**(11,647)**	**(1,073)**	**(1,087)**	**(76,597)**
Adj. due Acc'ting Chngs/Write-Ins		**370,046**	**(5,900)**	**(420,988)**	**-**	**(45,000)**
Sum Earnings + Adjustments		**357,448**	**325,391**	**300,832**	**401,280**	**597,613**
New Capital		**-**	**-**	**-**	**-**	**-**
Stockholder Dividend		**-**	**-**	**-**	**-**	**-**
Calculated Capital		**4,641,883**	**4,290,095**	**3,970,892**	**3,669,066**	**3,273,522**
Calculation Errors		**7,020**	**(5,660)**	**(6,187)**	**995**	**(5,736)**
Reported Capital & Surplus e.o.y.		**4,648,903**	**4,284,435**	**3,964,705**	**3,670,060**	**3,267,786**
Net Inc. Capital from Ops. + Inv.		**38,651**	**342,938**	**722,892**	**402,367**	**719,210**
Direct Adjustments in Capital		**318,797**	**(17,547)**	**(422,061)**	**(1,087)**	**(121,597)**
	5 Yr Avg.					
Cap. ROR from Ops & Inv.	**12.49%**	**0.87%**	**8.31%**	**18.94%**	**11.60%**	**24.20%**
Cap. ROR from Direct Adj.	**-1.87%**	**7.14%**	**-0.43%**	**-11.06%**	**-0.03%**	**-4.09%**
Cap. ROR fr'm Calc. Errors	**-0.06%**	**0.16%**	**-0.14%**	**-0.16%**	**0.03%**	**-0.19%**
Capital's ROR	**10.93%**	**8.16%**	**7.75%**	**7.72%**	**11.60%**	**19.92%**
Equalized ROR for Life Reserves + Cap.	**8.75%**	**8.13%**	**7.83%**	**8.15%**	**9.21%**	**10.45%**
ROR- NonBorr'wed Life Res. w/ Dir. Recognt'n	**8.33%**	**8.15%**	**7.82%**	**8.20%**	**8.76%**	**8.71%**
Degree of Participation	**96%**	**100%**	**100%**	**101%**	**95%**	**83%**

This rate of return on managed life reserves requires some explanations. First, this is an average across all of the insurers' life products, and therefore might have limited usefulness with respect to any specific policy. In particular, aggregate non-borrowed life reserves include reserves on term policies and supplemental riders. The rate at which these non-surrender-able reserves are increased varies from the rates at which cash-value policy reserves are increased/grown. Second, part of the distribution of Year N's investment income that becomes dividends in Year N does not, according to current statutory accounting rules, increase reserves until the following year (N+1) when they are applied to premiums or paid-up additions. The effect of such treatment is to reduce the denominator and thereby slightly overstate the rate or return on reserves. While this factor contributes to overstating the rate of return on managed reserves, the above-described assumption that

all net gains to capital arise from investment activities works to understate this rate of return. Work to correct for these factors' impact upon the rate of return on managed life reserves can be further studied if deemed material.

Table 2 also provides a summarized accounting of changes to total capital/surplus. While it can sometimes be useful to partition surplus into an asset valuation reserve and an interest maintenance reserves, such items are best understood as part of capital/surplus. In contrast, surplus notes - which sometimes are viewed as capital or surplus - function as subordinated debt in a financially-viable insurer. Table 2's changes in capital provide insights on the origin and sustainability of the rate of return on capital. **Table 2** also calculates the rate of return on capital.

Finally, **Table 2** also contains **the Degree of Participation** measurement. Additional insight regarding a life insurer's operating practices is gained from a comparison of the rate of return on capital with the rate of return on managed (a.k.a. non-borrowed) life reserves. In particular, **the Degree of Participation** measures the extent to which returns are distributed proportionately between reserves and capital, thereby providing insight regarding how or how well policyholders participate in the insurer's earnings. This measurement can only appropriately be calculated over the long term given the vagaries of the insurance industry's operating and accounting practices (for example, the ways in which capital gains are or are not available for contemporaneously increasing returns to policy reserves). Quite simply, if the long-term rate of return on reserves equals the rate or return on capital, then neither life policyholders nor capital-holders have subsidized (or been subsidized) by the other. While the degree of participation's variability contrasts markedly with mutual funds where all returns after "costs" flow to fund-holders, this characteristic is neither inherently good nor bad, but rather a policy attribute and life insurer operational characteristic that warrants understanding and monitoring.

Supplementing the above investment analysis, traditional measures of financial strength and performance are separately reported in additional tables available in our Comprehensive Reports on insurers. For example, total returns per asset class (bonds, real estate, etc.) and portfolio allocation measurements and turnover ratios can be calculated, and compared with industry averages and particular peers. Capital strength assessments such as capital/reserve ratio and portfolio allocations are certainly necessary measures. While the standard risk based capital (RBC) measurement compares capital with "a measure of required capital" to arrive at a ratio/percentage of actual to required capital, another new useful measurement is the level of portfolio risk. For example, given that individuals typically plan to be policyholders for the long-term and that returns are positively correlated with risk, in choosing among insurers with equal RBC measurements individuals would prefer, subject to their own risk constraints, insurers with higher portfolio risk, or Asset Valuation Reserve Risk Factor.

Investment analysis is only half of the financial analysis required to understand a life insurer's performance. To complete the analysis, insurance operations must be understood. Some straightforward adjustments of the Annual Statement's Analysis of Operations by Lines of Business isolate insurance and general operational expenses from investment related activities and facilitate reconfiguration of various line entries from a statutory accounting framework to one more akin to a GAAP income statement. For instance, total

mortality expense is calculated rather than using the Annual Statement's data for death benefits. Death benefits, after all, contain reserves released upon death which are not an expense, any more than bank withdrawals or mutual fund redemptions are expenses. Revenue adjustments also reflect transfers to and from the Separate Account, commissions on reinsurance ceded, and miscellaneous income.

Table 3 shows an insurance operations income statement for fictional insurer Big XYZ. Subsequently, expenses are compared directly with output (namely, coverage provided), so that one can, for instance, obtain average mortality costs/million dollars of coverage provided, as also shown in **Table 3**. Many have found that these new measurements facilitate comparisons that are more appropriate and useful than the traditional expense to premium ratios that are not comparable for insurers with very different mixes of cash-value and term policies. This efficiency perspective also avoids the

Table 3 **Big XYZ Insurer**

Years	2000E	2000D	2000C	2000B	2000A
Life Premiums (all figures in thousands)	**3,946,731**	**3,654,547**	**3,383,189**	**3,258,625**	**2,930,831**
Less Net Transfers	**276,902**	**236,248**	**152,401**	**95,442**	**62,661**
Plus Commissions on reinsurance ceded	**74,355**	**68,493**	**63,155**	**58,819**	**55,893**
Plus Net Gains Separate Accounts	**-**	**-**	**-**	**-**	**-**
Plus Ordinary Fees Ass. w	**54,435**	**45,970**	**-**	**-**	**48,459**
Plus Aggregate Write-ins	**24,237**	**19,950**	**38,275**	**37,047**	**42,441**
Equals: Total Net Premium +Non-Inv. Inc.	**3,822,854**	**3,552,712**	**3,332,218**	**3,259,048**	**3,014,962**
Mortality Costs	**246,405**	**235,821**	**199,005**	**185,599**	**181,452**
Misc. Benefits	**18,604**	**20,655**	**23,387**	**19,128**	**27,511**
Commissions Paid to Agents	**270,260**	**259,948**	**244,209**	**240,086**	**234,132**
General Expenses	**232,525**	**242,921**	**212,684**	**194,807**	**170,097**
Taxes and Fees	**62,017**	**54,839**	**51,823**	**48,675**	**47,210**
Federal Taxes	**41,319**	**1,292**	**67,985**	**112,684**	**154,584**
Misc. Operating Costs	**13,851**	**5,753**	**(2,507)**	**39,241**	**(2,631)**
Total Benefits Pd, Oper. Costs, & Taxes	**884,980**	**821,228**	**796,586**	**840,219**	**812,353**
Premiums Refunded As Dividends	**792,990**	**799,871**	**675,423**	**535,808**	**513,038**
Net Available from Premiums to Contribute to Reserves	**2,144,884**	**1,931,613**	**1,860,210**	**1,883,021**	**1,689,572**
Year-End Inforce in millions (MM)	**148,593**	**140,190**	**131,951**	**123,873**	**115,954**
Selected Operational Efficiency Metrics					
Mortality Costs/$MM of In-force Coverage	**1,658**	**1,682**	**1,508**	**1,498**	**1,565**

Table 3 continued **Big XYZ Insurer**

Years	2000E	2000D	2000C	2000B	2000A
Selected Scale, Focus and Trend Measures					
Life Reserves to Total Reserves	**51%**	**50%**	**48%**	**47%**	**45%**
Growth Rate of Face Amount Issued	**6%**	**5%**	**-3%**	**7%**	**4%**
First Yr Life Prem. to Industry FY Prem.	**2.10%**	**1.94%**	**1.75%**	**1.70%**	**1.60%**

inherent problems of traditional comparisons of premiums to benefits, which: 1) in combining investment earnings and/or reserves released data impair comprehension of the mechanics of a life insurer's business, and 2) in not recognizing the different mix of term and cash-value business that also impairs comprehension and comparability. Admittedly, while there are many different ways insurers can distribute mortality charges among all policyholders knowledge of an insurer's average of such costs is nonetheless useful. In particular, comparisons with industry and peer group averages can be especially insightful. Similarly, administrative costs and taxes are also calculated per million dollars of coverage. In addition, traditional commissions/premiums ratios are calculated, as are sales growth and persistency rates. Some selected measurements with respect to an insurer's scale, focus, and trends are also reported in Table 3. Other operationally-important information, such as: 1) accounting for changes in life reserves and, 2) the "vintaging" of insurer's in-force pool of business are also available in our Comprehensive Reports, with the latter providing valuable insights regarding an insurer's operating efficiencies.

The above transformation of Annual Statement data provides new understanding and insight regarding life insurers' financial performance, and consequently new ways of assessing the value their policies can provide. Based upon the fact that this analysis uses averages calculated on the insurers' entire life insurance product line and pool of insureds it has some significant limitations. Such could be corrected by refinements of the analytical model or changes that improve Annual Statement data. Nonetheless, the data reveals significant differences in the financial performance of insurers. These differences, respectively, underlie and imply important differences in the value policyholders have received and are likely to receive in the future from various insurers.

Past performance is, of course, obviously, no guarantee of future outcomes. Certainly, what is true about mutual funds and other investments is also true about participating life insurance policies over the many decades they can be in-force. Nonetheless, understanding insurers' financial performance is the first necessary step whether selling or buying or renewing a life insurance policy. It is only when one has specific insurer information and an industry-wide perspective upon such that one is able to make good recommendations and/or decisions regarding life insurance.

To obtain actual historical data and valuable analysis as shown above on any major life insurer in the US, contact BreadwinnersInsurance.com. Better decisions begin with better information and better understanding.