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Special Bulletin: Making Sense of the Lawsky "Shadow Insurance" Report
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The purpose of this communication is to keep professional advisors and trustees informed on the recent "Shadow Insurance" Report by New York Regulator Benjamin M. Lawsky. Summarized in this bulletin are the following:

1. A summary of the report
2. The importance of reinsurance for life insurance carriers
3. Responses from three insurance carriers named in the report
4. Our firm's position on the topic and the impact on recommendations we make to clients

Summary of Shadow Insurance Report

In June, 2013, Benjamin Lawsky, the New York Superintendent of Financial Services, released a controversial report on the use of "shadow insurance" by NY-based life insurers. The report claims that through "shadow Insurance" some insurance carriers have understated liabilities (reserves) in order to improve the appearance of their financial strength. Reinsurance is insurance for insurance companies that allows carriers to shift future liabilities to another company at a discount. Reserves are conservative calculations of future liabilities the insurance regulators require to be set aside to cover future claims. The reinsurance arrangements mentioned in the report are: Conditional Letters of Credit, Hollow Assets, and Naked Parental Guarantees. Additionally, the carriers named in the report were MetLife, AIG, Lincoln Benefit Life, Transamerica, Prudential, Hartford, Genworth, John Hancock, Reliastar, and Lincoln National. *Note: New York has standing to investigate only life insurers based in New York. New York Regulators are calling for other states, or the federal government, to conduct similar investigations in other states.*

It is important to point out that the insurance carriers named were stock companies, not mutual companies. The stock companies have generally been the ones offering the more attractive, low-cost guarantees to consumers. The capital strain from these products and how they are reinsured is at issue. Insurance products from mutual carriers are generally characterized by higher premiums and greater cash value accumulation than products offered from stock carriers. Because of these differences, mutual carriers would not have the same capital strain on their balance sheets as stock carriers. However, the Lawsky report referenced surplus notes, which, although not exclusive to mutual insurance carriers, are one of the few capital raising techniques available to them. This is to say, although mutual carriers have not been specifically pointed out in this report, we would be remise to assume any carrier is unblemished.

Importance of Reserves for life insurance carriers

Many of the life insurance products sold over the last decade include long-term, contractual guarantees that may be promised for 30, 40, or even 50 years into the future. These products have a street name of "Guaranteed Universal Life" but technically should be described as "Universal Life insurance with secondary premium and death benefit guarantees backed by the claims-paying ability of the insurance carrier." Until recently, the majority of guarantees were promised for the lifetime(s) of the insured(s), which could be age 120 or beyond. Universal Life insurance policies with secondary death benefit and premium guarantees are typically characterized by minimal cash value accumulation and low premium. Assuming the premium is funded timely every year, this type of policy provides noticeably higher internal rates of return on death benefit at life expectancy when compared with other policy types that provide the client with greater flexibility.

As an industry, insurance agents have fallen prey to the illusion that choosing the carrier with the lowest premium, longest guarantees, and highest death benefit at the expense of little to no policy cash value in the future is always best for the client. While some situations may call for that type of design, it should only be recommended after completing a prudent policy design and selection process. Without taking into account other pertinent design criteria such as carrier strength, history of policyholder treatment, and cash value accumulation, the agent is locking the client into a product with little room to accommodate future change.

The importance of adequate reserves is that they allow insurance carriers to keep their promises to policyholders. When a policy has little potential for cash value accumulation and projects $0 cash value at the insured's life expectancy, the policy's cash value is unable to be included in the reserve requirement calculation. For example, when a Whole Life policyholder passes away with $100,000 of death benefit and $50,000 of cash value, the insurance carrier applies $50,000 of cash value to its reserves. When a Guaranteed Universal Life policyholder passes away with $100,000 of death benefit and $0 of cash value, the insurance carrier is on the hook for all $100,000 because there is no cash value to apply to its reserves. Since the creation of Universal Life with secondary guarantees, there has been an on-going debate about the necessary level of reserves to fund future promises.

An inherent conflict exists between Regulators who strive for conservative assumptions as a basis for setting reserve requirements to protect policy holders, and insurance carriers that need more reasonable reserve requirements to maintain profitability. This becomes even more apparent in our sustained, low-interest rate environment. This conflict has created a shell game of sorts between regulators and insurance carriers.

Responses from Insurance Carriers

- **Lincoln** – one of the first to respond stating, "We use regulator approved and adequately capitalized captives as part of our reinsurance strategy. Lincoln supports transparency." Additionally, after this report was issued, Lincoln received a rating increase from Moody's, which is significant as there have been few increases from the rating agencies recently.
- **MetLife** – Captive reinsurance is "a cost-effective way of addressing overly conservative reserving requirements."
- **Prudential** – "Prudential uses captive reinsurance in our domestic insurance operations to more effectively manage our capital on an economic basis and to enable aggregation and transfer of risks. Our captives are capitalized to a level consistent with AA financial-strength rating targets." Additionally, Prudential just purchased Hartford's life insurance business.

Colton Groome & Company's Response and Impact on Client Recommendations

As an independent insurance advisory firm, with over 60 years of providing trusted life insurance solutions to families, businesses, and trustees, we are, with the guidance from our Broker-Dealer ValMark Securities, Inc., paying close attention to:

1. The insurance carriers involved and the type of reinsurance arrangements they utilize.
2. The different types of reinsurance arrangements and level of risk associated with each.

Before we can make informed recommendations, we will need to obtain more information from the insurance carriers in response to the Lawsky Report. We are hopeful that we will learn more over the next month, but the real effect may not be fully known for the next 12-18 months.

What we can do today:

1. Offer clients best-in-class choices customized to their situation. As an independent firm not employed by a single insurance carrier or "producer group," we offer life insurance strategies to clients that range from Mutual Carriers with AAA ratings to Stock Carriers with competitive guarantees backed by separate accounts that the client controls.

2. Recommend and implement long-term life insurance strategies instead of focusing solely on bottom-line pricing. We have done this consistently for our clients through our affiliation with ValMark Securities, Inc.

3. Continue providing value to our clients through an independent, disciplined, and prudent life insurance review and selection process. This process includes industry-leading tools such as:

   Life Insurance Design Questionnaire® – similar to a Risk Tolerance questionnaire for an investment portfolio, we document the client's goals for life insurance, desire for flexibility, premium tolerance, preference for carrier financial strength, need for diversification through carrier selection, etc.

   Policy Management Statement™ – once the Life Insurance Design Questionnaire® is complete, a Policy Management Statement is completed for the policy that documents the client's goals, the rationale for policy type, carrier selection, and the strategy for managing the policy into the future.

   PURE Process (Private Underwriting Rating Evaluation) – a confidential, client advocacy process by which our expert underwriters represent, clarify, and coordinate details of the application to produce the most favorable medical underwriting offers possible. We then assist clients in choosing the medical underwriting offer that most closely aligns with their goals for life insurance as indicated in their Life Insurance Design Questionnaire®.

   STAR Rankings™ (Carrier Strength Tracking & Assessment Report) – a carrier strength assessment tool that goes beyond the ratings provided by rating agencies such as Moody's, Fitch, Standard & Poor's, and A.M. Best. Stars are assigned according to specific criteria that rank carriers based on stock price, outlooks from rating agencies, exposure to troubled assets, price-to-book ratio, capital position, ability to raise capital, commitment to life insurance as a primary business, etc.

   TOLI Vault™ (Tracking of Life Insurance) – a technology platform that allows more consistent policy monitoring, performance tracking and annual reporting so clients are more informed and positioned to make adjustments to their policies along the way.

There is no doubt that the Lawsky report is concerning and may uncover ugly truths about some carriers. As Warren Buffet said, "Only when the tide goes out do you discover who's been swimming naked." However, the U.S. life insurance industry has withstood the test of time since the mid-1700's and continues to play a crucial role in the protection and security of families.

Throughout the next 12-18 months, we will find carriers that are ideally positioned for increased reserving requirements and regulatory pressures and some that are not. Those that have prepared themselves may have a history of conservative decision making and an AAA financial rating, a strong international presence that balances a carrier's U.S. business, or a portfolio of innovative "hybrid" life insurance products that provide competitive contractual guarantees and cash value accumulation within a separate account portfolio controlled by the client.

Whatever happens, we maintain the confidence that times like these create opportunities to emerge and for the industry to become even better.

"A bend in the road is not the end of the road ... unless you fail to make the turn." – Unknown.

<u>Sources:</u>

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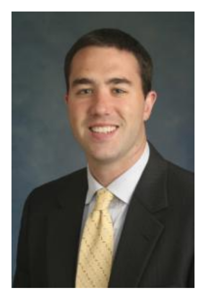
About the Author

Colton Groome & Company was founded in 1950 on the principals of precision, perseverance, and thoroughness. More than 60 years later, we continue to practice these principles by providing trusted insurance solutions to families, advisors and trustees. Our team of expert insurance advisors works closely with our clients to deliver a life insurance program that is comprehensive yet easy to understand, so our clients feel more confident about their financial futures.



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Tate joined Colton Groome & Company in 2003. A Certified Financial Planner ™ and Chartered Life Underwriter™, Tate has more than ten years of experience providing trusted life-insurance solutions to individuals, trustees, and advisors. He earned a Bachelor of Arts degree in Communication Studies and Spanish from UNC Chapel Hill in 2001. Prior to joining Colton Groome & Company, Tate taught elementary education for at-risk youth. He is a member of the Top of the Table and Million Dollar Roundtable®, serves on the Boards for his local NAIFA committee, South Buncombe Youth Basketball, Skyland United Methodist Church, and is longtime volunteer with Big Brothers Big Sisters and the YMCA of Western North Carolina. He loves spending time with his wife Anna and coaching his three kids in Basketball, Soccer, and Baseball. Tate can be reached by phone at (828) 252-1816 x 111 or email: <u>tgroome@coltongroome.com</u>