BCG COMPANIES

DUE CARE BULLETIN

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Life insurance due care requires an understanding of the factors that impact policy performance and drive product selection.

M Financial Group continues to lead the industry in life insurance due care and client advocacy, providing valuable insight and analysis that delivers significant value to clients.

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The Impact of the Current Economic Environment on NLG and Annuity Products

Increasing Cost of No Lapse Guarantee UL

There are two factors that drive a significant portion of the cost of No Lapse Guarantee UL products (NLG): the cost of capital and the carrier's assumption about future investment returns.

Cost of Capital

In order to offer more competitive NLG and term products, almost all carriers rely on capital solutions to fund the reserve costs of the long term guarantee. Most carrier capital solutions are based on some type of financing. As a result, the cost of these solutions is directly tied to the carrier's financing costs. Because carrier financing costs have significantly increased over the last six months, the capital solution costs have also increased.

To offset these higher costs, we see carriers taking three possible actions:

- Raising prices, to recover the increased cost of capital
- Reducing the length of the guarantee to reduce the reserve costs
- Withdrawing from the market until better (or some) financing becomes available

Survivorship products, older age single life products, and long duration level term products rely more heavily on these capital solutions. As a result, we are beginning to see carriers increase prices or withdrawing from the market for survivorship and 30-year term products.

Because this is a systemic issue, impacting the entire industry, until capital becomes more readily available at lower prices, new issues of NLG products will continue to face upward price pressure.

Future Investment Returns

When establishing guaranteed premiums for NLG products, carriers typically assume that over the life of the policy their investment earned rate will gradually increase to some higher long-term average, as opposed to the relatively low level that we have experienced in the recent past. As we continue to see downward pressure on interest rates, and because many expect this downward pressure to continue for an extended period of time, carriers are re-evaluating their long-term interest rate assumptions. A lower assumption in the projected investment earnings rate increases the guaranteed premiums.

AXA is an example of a carrier that pulled its NLG product because they didn't feel they could remain price competitive using their current expectation of future portfolio rates.

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Please note that increases in the cost of capital or reductions in the future investment returns are putting upward price pressure only on ***new*** issues of NLG products.

Policies already issued with guaranteed premiums cannot have those premiums increased. The risks described above are assumed by the insurance company and the risk to the existing policyholder is solvency, not premium increase.

Upward Price Pressure on Annuity Products

Variable Annuities with guaranteed living benefits are another product line experiencing significant pricing issues due to the recent decline in the equity market. These annuities offer policyholders the opportunity to invest premiums in a variety of funds and also provide guaranteed minimum withdrawals often for the life of the insured, independent of the return of the underlying funds. These products expose the carrier to two major risks:

- Equity risk – the risk that the underlying funds underperform relative to the guaranteed minimum withdrawal guarantee
- Longevity risk – the risk that the insureds outlive the ability of the underlying funds to provide the withdrawals for the life of the insured

Most carriers offering variable annuities with guaranteed living benefits use hedging programs to protect themselves from market declines. Because the cost of these hedging programs has increased, variable annuity carriers are faced with the decision of whether to, for newly issued policies, increase the price of guaranteed living benefits or change the terms. Some carriers may decide to withdraw from the market altogether.

Further, most carriers rely upon some asset based revenue to recover their expenses in the variable annuity business. Often this is a portion of the M&E expense charged to the client. To the extent that market values have declined, in many funds more than 40%, the revenue received by the carrier to cover its expense, often a fixed expense, has declined in proportion. This reduction in carrier revenue to cover expenses increases the upward price pressure on new sales of variable annuities.

Fixed annuity products are not typically backed by hedging programs; however, there may be increased pressure to raise prices on fixed annuities in response to lower portfolio earnings rates driven by the economic environment (increased asset defaults, limited availability of high quality investments, and lower earnings due to the economic slowdown).

Variable annuities are long-term investments designed for retirement. The account value is subject to market fluctuations so that, when withdrawn or annuitized, it may be worth more or less than its original value. Optional riders, such as guaranteed living benefits, may be available for an additional fee. All product guarantees, including income guarantees, are subject to the claims-paying ability of the issuing insurance company. Withdrawals of taxable amounts are subject to income tax and if made prior to age 59 1/2, may be subject to a 10% federal tax penalty. Withdrawals will reduce the guaranteed benefits and account value. ***Investors should consider the investment objectives, risks, charges and expenses of any variable annuity product carefully before investing. This and other important information about the investment company is contained in each product's prospectus, which can be obtained by calling 804.648.0005. Please read it carefully before investing.***

For More Information

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