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How COVID-19 and Interest Rates Affect Life Insurance

Two major developments practitioners should know about

Practitioners should be aware of two major developments in 2020: (1) changes in procedures to deal with COVID-19; and (2) the effect of low interest rates on life insurance performance.

COVID-19

COVID-19 caused underwriting and technology changes as well as an increased interest in the cash value life insurance and life settlement markets.

Underwriting. The proposed insured must now answer COVID-19 questions on the application and sign both the application and a health statement on policy delivery.

The process of getting medical exams got easier for proposed insureds ages 65 and under who have recent medical records. Because of the reluctance of individuals to allow strangers into their homes to do medical exams, many companies increased the amount of insurance these proposed insureds could get without undergoing an exam.

Insurance companies have also become more restrictive in how much insurance they'll issue to older proposed insureds (that is, those who are over age 65). If an older proposed insured has a health impairment that would result in a rating below a certain class (usually class B), the company won't issue a policy or will limit the amount of insurance for that policy. For example, Prudential has reduced the amount of insurance it will issue to $10 million on a single life and $20 million on two lives.

Technology. The process of completing the application got easier for everyone, as the agent and the client no longer needed to meet in person. Instead, they can now complete applications using DocuSign or a similar service. The insurance company can get medical, financial and other pertinent information by phone and deliver policies electronically. For smaller cases ($1 million or less), the underwriting process can be done electronically, and policies can be issued in about a week from start to finish, if the appropriate information is available. If you have a client who's reluctant to get insurance because of the risks of meeting in person, make sure the client knows of this change.

Cash value life insurance and life settlements. COVID-19 has adversely affected some clients' finances. People have been laid off from jobs. Clients have taken pay cuts or retired earlier than they planned. Business owners have seen their businesses go dormant or close. As a result, clients may be interested in taking advantage of existing cash value life insurance or participating in the life settlement market.

Life settlements may also help clients who are suffering financially due to COVID-19. I recently worked with a client whose mother had a substantial life insurance policy that she could no longer afford. The client also had a business that had a cash crunch. He was able to get a life settlement that both ended the drain on cash trying to keep the policy in force as well as provide the funds needed to float his business. Clients who have life insurance (including convertible term) and whose health has changed for the worse since they bought the insurance may have an opportunity to sell the policy for more than it's worth than if they surrender it.

Low Interest Rates

Low interest rates have had a profound effect on life insurance policy performance, except for variable policies. All other in-force policies that have policy

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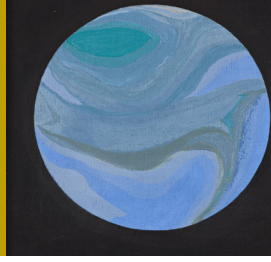


performance based in whole or in part on the performance of the insurance company's general account (the money the insurance company invests itself), including whole life (WL), general account universal life (UL), universal life with secondary guarantees (GUL) and equity-indexed universal life (IUL), are affected because with low interest rates, the insurance companies earn less on their investments.

Reserves. Insurance companies hold reserves in part based on the quality of the underlying assets. If a company's asset quality is low, it will have to hold more in reserves. Highly rated debt securities are important components of any insurance company's portfolio. Companies hold anywhere from 50% to 80% of their assets in those bonds. The asset portfolio determines how companies price products along with the performance of existing products. Lower interest rates change assumptions used in pricing new products and may impair the performance of existing policies.

Pricing of products. Lower interest rates can cause the premiums for UL and GUL policies to go up for new insurance because the low rates squeeze the profitability of companies. If your client is looking for lower premiums, consider IUL policies with secondary guarantees. Those guarantees are usually for 20 years or longer. Using a conservative earnings assumption, 70% of the maximum assumption, the chances of the policy lapsing before the intended date are remote. The premiums may be lower than those for GUL, and there will be cash surrender value available.

In-force policies. The dividends on existing WL policies and the performance of UL and IUL policies are affected by the low interest rates. Here's how: An insurance company owns a portfolio of assets. Assume that all the debt it owns comes due in one to 10 years and that the company invests an equal amount each year. Debt the company acquired 10 years ago pays a higher interest rate than debt acquired now. Assuming a straight line decrease in interest rates over the 10 years, as a debt instrument matures, the company must replace it with a debt instrument today that has a lower interest rate. If the interest rate 10 years ago was 7% and now it's 2%, the company gets 5% less on the new debt instrument. This affects the average rate of return of the entire portfolio. This calculation is called the "portfolio crediting method," which almost all insurance companies use. It will lag the interest rates in effect at any given time because of the investments that were made in the past. The average is always affected by those past investments as long as they're held. The insurance company credits interest on UL and sets cap rates (the maximum return that a policy can receive based on the performance of an index) on IUL based directly on those rates. Dividends on WL are somewhat affected as well. As can be seen, with higher interest debt being replaced with lower interest debt, the average goes down.

Illustrations that were done when a policy was first issued aren't pictures of what's happening today.

IUL policies guarantee that regardless of how poorly the selected index performs, to the extent that it affects policy values, the percent credited can't go below zero. (The policy will lose value because of the expenses and cost of insurance taken out.) To do that, the insurance company has to set enough cash aside so that the zero return is achieved. Assuming that an insurance company's earnings rate is 4%, it would have to set aside a little more than $96 out of every $100 it receives to cover that guarantee. It purchases options (for example, puts and calls) to protect it if the index goes up. The maximum rate credited for a segment (insurance jargon for investments made in an index in any particular month until maturity) is determined by the index options that the company can purchase. If its option budget is 5%, it can buy options that produce a higher cap than if it only has 4% to spend. The insurance company will set a cap rate based on the rate of the options. (Cap rates change monthly and apply to each new segment created that month. That includes premiums received and the value of a segment that matures that month.)

Accordingly, illustrations that were done when the policy was first issued aren't pictures of what's happening today. Remember that an illustration is a projection of what will take place in the future if none of the company's assumptions change. They're invalid as soon as they're printed. And, because those portfolio rates, lagging the actual interest rates, will continue on

a downward trend, even if interest rates today start to go up, future returns will be more negatively affected. That's because if an insurance company, as required by the National Association of Insurance Commissioners Guidelines, makes a projection based on its returns now, its future returns will be lower. The portfolio rate today is higher than the portfolio rate next year. Unless a client asked for projections using lower rates than the assumptions used at the time the policy was taken out, the actual performance of the policy will be worse than was originally illustrated. If your clients are getting in-force illustrations today, because there will be further decreases in performance, they should ask for a rate lower than what's currently projected.

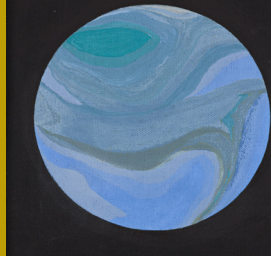
Practitioners should advise clients to review all existing split-dollar arrangements.

Split-dollar arrangements. Low interest rates also affect split-dollar arrangements (that is, one party pays the premiums for another and shares in the benefits of the policy). In 2001, the Internal Revenue Service issued Notice 2001-10, and in 2003, it enacted Treasury Regulations Section 1.7872-15, creating a new kind of split-dollar arrangement—a loan arrangement. All premium payments are treated as loans. The term of the loan can be whatever the parties agree to. The minimum interest rate without triggering adverse consequences is determined by the applicable federal rate (AFR) in effect for the term of the loan at the time the loan was made. Loans of three years or less use the short-term rate; loans from three to nine years use the mid-term rate; and loans for longer than nine years use the long-term rate. The regulations do something that can't be done in any other related party loan transaction—a loan can be made for the life of the insured. To determine the appropriate AFR, the insured's life expectancy is determined using the annuity tables under Treas. Regs. Section 1.72-9. If the insured's life expectancy is more than nine years, a loan for life uses the long-term AFR. In December 2020, the long-term AFR was 1.31%. For older insureds, it may be the mid-term or even short-term rate. Regardless of the term used, the interest rate for that loan won't change during the term of the loan.

Practitioners should advise clients to review all existing split-dollar arrangements. All arrangements done before 2001 were economic benefit arrangements. As in all split-dollar arrangements, there are two parties: the party paying some or all of the premiums and the party that determines who gets the death benefit. In an economic benefit arrangement, one party *advances* (not loans) money to pay premiums in return for receiving back, in most cases, the greater of the cash value or premiums paid. The other party names the beneficiary for the difference between the face amount of the insurance and what the premium advancer is due. The value of the benefit is determined by the cost of annual renewable term insurance for that year at the insured's then age. In 2001, Treasury created Table 2001 to be used to determine that cost. The annual renewable term rate goes up every year as the individual gets older. If two lives are insured, the rate is based on the likelihood of both dying in the same year. When one of the insured dies, the cost is determined by the rate for the survivor, a much higher number. These arrangements can be changed to loan arrangements.

For clients with existing economic benefit arrangements, the interest due on the loan may be less than the taxable term cost. Compare the economic benefit of the receivable with the interest that would be due if the economic benefit arrangement was converted to a loan arrangement. One of my clients converted six split-dollar arrangements with an economic benefit of $120,000 to a loan with interest of $30,000. Because it's a loan for the life of the insured, the interest rate remains the same for the life of the loan. (You can convert to a shorter term loan if so desired. At the end of the term, the loan will have to be renewed at whatever rate is in effect then. Because the long-term rate is so low, I would strongly consider doing the loan for life.)

Be careful with grandfathered equity split-dollar arrangements. In that scenario, the premium advancer is only entitled to the premiums paid, and in most cases, the premiums paid are less than the cash surrender value. There's no tax on the accrual of cash value. As long as that arrangement doesn't change, the owner isn't taxed on the excess of the cash value over premiums paid. Changing to a loan arrangement is a material change that will force that taxation. It's taxed



as ordinary income.

If your client has an existing loan arrangement, see if the current interest rate is lower than the rate on the existing loan. If so, it makes sense to roll the existing loan(s) into a new one for a new term or the life of the insured. If there are multiple loans, it will simplify the bookkeeping. Interest may be accrued instead of paid. One additional benefit occurs if the owner is a grantor trust, and the grantor is making the loans. Because of the grantor trust status, until the trust changes to a non-grantor trust or the grantor dies, there will be no original issue discount attributed to the accrual, eliminating any payments and any gift tax consequences.

Loan split-dollar arrangements are a good way of exiting a premium finance strategy. In a typical premium finance arrangement, a trust owns the life insurance and is the borrower. The cash value of the life insurance is used as collateral. The party setting up the trust (the grantor) guarantees the loan and puts up additional collateral if the cash value of the life insurance isn't enough to cover the loan. At some point, because of future uncertainties regarding interest rates, policy performance or the ability to be able to continue to get favorable loans, it behooves someone to end the arrangement. The grantor paying off the loan outright would be making a taxable gift to the trust, including interest paid and payable. A loan split-dollar arrangement obviates the gifting problem. It can also be done so that some of the loan is paid back with the cash value of the policy, but not so much that the policy will lapse in the future. The balance of the loan can be repaid using split dollar. Although it's now the grantor who's putting up the capital, because of the low interest rates today, the interest rate will be much lower than the interest rate of the financed arrangement. And ostensibly, the grantor may still have access to some or all of the loan if the cash value is enough to repay it without risking the policy ever lapsing.