MICHIGAN LAWYERS WEEKLY
www.milawyersweekly.com
Vol. 23, No. 15
February 23, 2009
DOLAN MEDIA COMPANY

The financial crisis demands a close look at life insurance

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Like all other areas of financial services industries, the life-insurance industry is feeling the shock waves of the financial crisis. Life-insurance practitioners must be cognizant of the changing environment and the potential impacts on clients and fiduciaries.

The financial health of the industry

Because of state oversight and capital requirements, the insurance industry is in better shape than other financial-services industries.

State regulators have held the line, and the National Association of Insurance Commissioners (NAIC) recently rejected an industry request to loosen capital requirements.

Even the well-publicized problems of AIG have not affected its life-insurance subsidiary, as AIG has not been permitted to use excess capital at its insurance subsidiaries to bolster the balance sheet of the parent company.

However, insurance carriers have varying degrees of exposure to the subprime-mortgage-backed securities, as well as the carriers' commercial mortgage portfolios.

That exposure is reflected in rating-agency reports, but in some cases the total effect of the subprime crisis and the real estate downturn is not yet fully recognized. Although the situation is not dire, increased diligence in reviewing insurance policies and the issuing carrier is necessary.

Beyond ratings and balance sheets

In the past, due diligence on a carrier meant looking at its ratings.

Although that is still relevant, fiduciary standards should include a more careful analysis of the company and its balance sheet.

For most insurers, that is not easily done. Life-insurance operations may be consolidated in the balance sheet of a corporate parent, as in the cases of AIG, Sun Financial and ING.

Such data are available, and insurance professionals have access to them. There are also data available about the maximum subprime exposure of the carriers, and counsel and/or a fiduciary should request that information.

Consolidation

Although insurance company failures are a possibility, most experts say there will not be a rash of failures, and that failures probably will occur among smaller marginal carriers.

A significant industry consolidation is possible as companies move to strengthen their balance sheets. For policyholders of the acquiring company, that creates no immediate issues.

However, to increase profits, the acquiring company may try to lower crediting rates on the acquired block of business or raise policy costs for policyholders of the acquired company. In such situations, regular policy reviews are essential.

Products at risk

The most obvious area of concern is variable life insurance, which is based upon the performance of equity securities. With the drop in stock values, the cash values of such policies have plummeted.

The loss is deepened by policy expenses and the costs of insurance (as cash values drop, the amount at risk for the carrier increases, and so do costs).

To the extent the client was relying on variable life insurance to provide a death benefit, the cost of keeping the policy has gone up dramatically. Such policies need to be re-evaluated and analyzed.

The sustained low interest rates and real estate market conditions have caused a decline in dividend rates for whole-life policies. Although such products often are still strong performers, future premium requirements probably have changed from clients' original expectations. The potential for such changes needs to be identified before costs become prohibitive.

The new generation of equity-index products often provides for minimum growth regardless of market performance. Such products are based upon the abilities of carriers to hedge market risk.

As market volatility has increased, the cost of hedging has in many cases become prohibitive. There is also concern about counterparty risk on hedged transactions.

The sustainability of such products to a prolonged market decline needs to be considered, as well as the overall financial position of the carrier issuing the policy.

The estate tax

While the potential for permanent estate-tax reform is beyond the scope of this article, the economic situation and the proposed budget deficits appear to have dimmed the prospect for a permanent freeze of the 2009 rates and exclusion limits.

Congress appears likely to extend the 2009 rates for a limited period. That would eliminate the potential of no estate tax in 2010, but retain the uncertainty of what happens when the current law sunsets.

In addition, there are proposals before the U.S. House Ways and Means Committee to limit intrafamily and other entity discounts that could limit the effectiveness of common estate-planning techniques.

In analyzing clients' insurance needs, we must consider the risk of higher estate tax rates and lower lifetime exclusions.

Life settlements and premium finance

Tight credit markets have affected the availability of premium finance and the pricing of the life settlement market.

Although premium finance funding is still available, it is increasingly focused on the use of equity-indexed products and future market returns.

Clients need to understand the risks associated with these transactions in terms of higher interest rates in the future, the performance of the equity index and the financial capacity of the carrier to sustain the product quoted.

Some premium finance lenders are no longer able to fund the ongoing premiums included within the terms of their existing financing. That can leave clients in a difficult situation.

Concurrently, the life settlement market has become more selective because of a variety of factors, including reduced capital commitments by policy purchasers and the use of longer life expectancies based on 2003 census data.

Although that market remains vibrant, it no longer can be viewed as a secure exit strategy for the owner of a policy, particularly a premium financed policy.

Life insurance remains a practical and vital aspect of family protection, estate planning and business succession.

The current financial crisis has caused practitioners to re-evaluate perceptions of many financial products and the nature of the advice clients receive in connection with the acquisition, ownership and disposition of assets. Life insurance is no different and requires a new level of thought and diligence.

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