2021 Dividend Interest Rate Perspectives

The Continued Toll of Low Interest Rates

Life insurance carriers commonly market the Dividend Interest Rate (DIR) on participating whole life policies to consumers. With carrier investment yields continuing to decline and historically low bond yields, unsurprisingly the bulk of the 2021 DIR announcements declared a reduction in the DIR compared to 2020 DIRs.[i]

Carrier	2021 Dividend Interest Rate (DIR) [i]	2021 DIR Change	2019 Dividends Paid ($000s) [i]
Northwestern Mutual	5.00%	0.00%	5,998,860
New York Life	5.80%	-0.20%	2,043,187
Mass Mutual	6.00%	-0.20%	1,671,109
Prudential	*	*	1,570,722
Guardian	5.65%	0.00%	967,943
MetLife	3.80% to 6.10%	-0.20% to -0.75%	133,113
Ohio National	4.00% to 4.70%	-0.50%	112,994
John Hancock	3.25% to 4.25%	-0.50% to -0.75%	109,996
Penn Mutual	5.75%	-0.35%	98,433
Brighthouse	4.35%	-0.35%	5,103
New England	4.30%	-0.35%	4,052

*Prudential doesn't disclose the DIR but announced a reduction of 9.6% in the expected 2021 dividends. Virtually all policyholder dividends are paid in policies under Prudential Legacy Insurance Company of New Jersey.

The Impact of Dividend Reductions

Dividends are a key factor in the ways consumers use whole life today. With the reductions in dividends, whole life policyholders need to request inforce illustrations to determine the impact on their policy. Lower dividends on participating whole life may cause:

- Policy termination
- Lower cash value
- Lower death benefit
- Higher out of pocket premiums
- Reappearing premiums
- Inability to borrow future premiums

At-Risk Policy Structures

How policies are structured, premiums are paid, and features used (i.e. policy loans taken to pay premiums) may influence a policy's reliance on the dividend performance. Some policies will be well positioned to weather declines in dividends. However, there are several whole life policy situations that are particularly susceptible to being adversely impacted by reductions in dividends. These include:

1. Policies that are relying on dividends to pay premiums in full or partially.
2. Policies with loan balances or plans to borrow from the policy in the future.
3. "Blended" policies that used a combination of base whole life and some term insurance element to lower the originally expected premium amount.
4. Policies relying on significant growth in policy death benefit or cash value from dividends to achieve coverage objectives.

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Perhaps the best way to demonstrate the impact of dividend reductions is to review some case studies from real policyholders.

Case 1 – Premiums That Did Not Stop

A client purchased a $5 million base whole life policy in 2014 expecting to pay only 10 premiums. After 5 years, dividend reductions resulted in the need to pay 15 total premiums rather than 10…a 50% increase in the expected outlay.

Impact: 50% More Premiums

Case 2 – Lower Cash Values and Death Benefit

A client purchased a $4.5 million all base whole life policy with 10 guaranteed premiums in 2016. A new inforce illustration based upon the new reduced 2021 dividend scale showed long term non-guaranteed cash value and death benefit growth were reduced by 51% after 40 years compared to the 2016 illustration.

Impact: 51% Less Cash Value

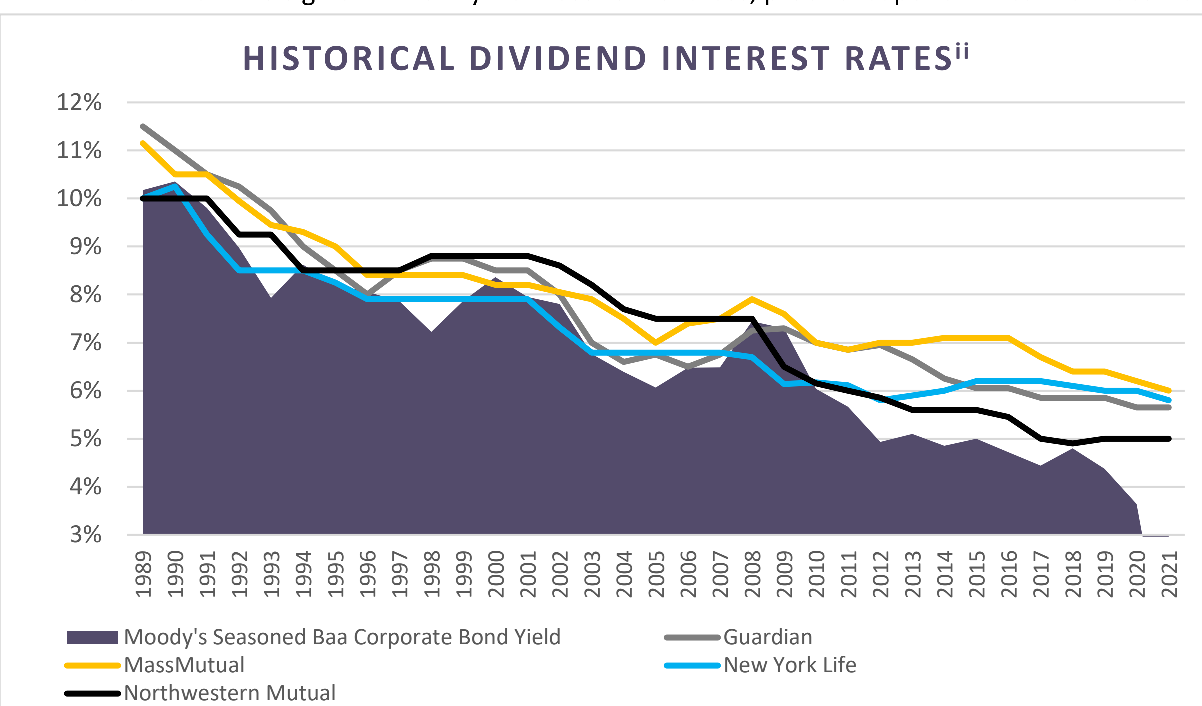
Case 3 – Blended Policy Requiring Higher Premiums

A client purchased a whole life policy in 2004 that was $500,000 of base whole life coupled with $2,500,000 of additional protection comprised of term insurance plus paid-up additions. The premium at time of issue was $31,000 payable until death. Due to dividend declines, by 2017 the client was required to pay $39,000 premiums (a 26% increase). If dividends declined another 1%, the client would have to pay $50,000 per year to maintain the original death benefit…a 60% increase.

Impact: 26-60% Higher Premiums

Interpreting DIR Movement

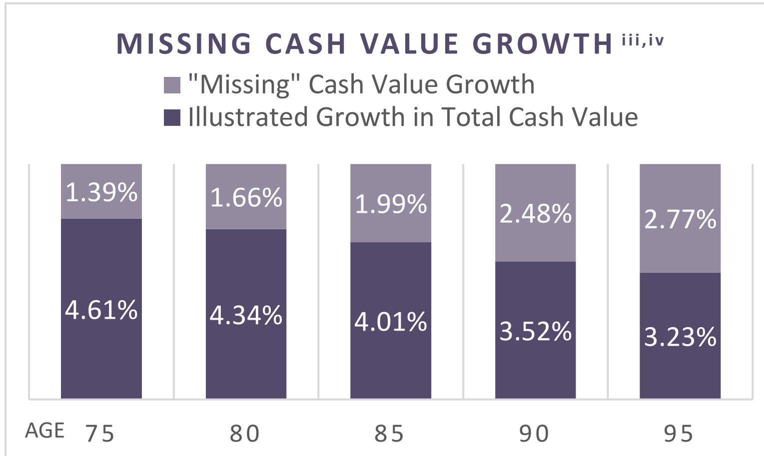
DIRs have been generally declining for decades[ii]. They seemed to move similarly to Baa bond yields until around the 2009 when DIRs started departing widely from Baa yields for reasons unknown. Is a carrier's decision to maintain the DIR a sign of immunity from economic forces, proof of superior investment acumen, or simply pandering to the high visibility of DIRs in agent sales pitches and carrier literature? Should a decline in the DIR be viewed as poor investing or a prudent reflection of the continued press of very low interest rates for many

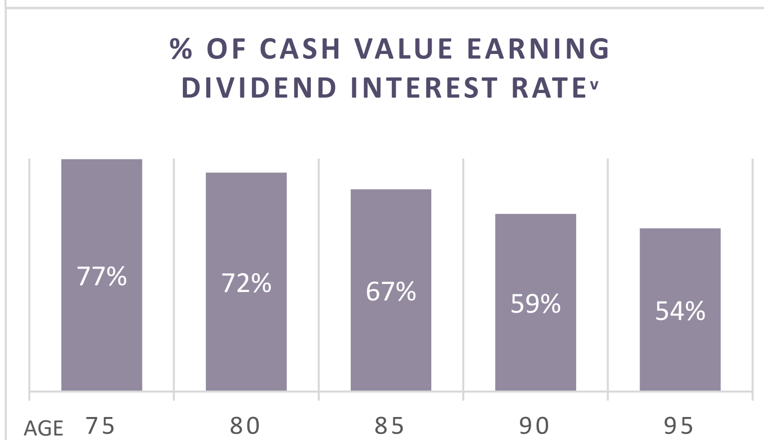


years? Unfortunately those decisions are made behind doors closed to the public so the rationale is always a mystery. The initial table in this paper provided a glimpse into the vast number of carriers making declines in DIRs. Carriers are clearly feeling the press of low interest rates over many years. If a carrier's DIR changes seem to be disconnected from economic reality for several years, it could be a good indicator of an overdue change. At a minimum, outliers from general trends probably should be viewed with a critical eye and a bit of skepticism as no carrier is immune to the rate declines.

Understanding Dividends

Dividends on participating whole life insurance are a complex (and unfortunately undisclosed) calculation comprising elements of insurance carrier mortality experience, expenses, and interest credited. The interest element, known as the Dividend Interest Rate (DIR), is a rate that is commonly referenced in sales illustrations and marketing materials, but isn't a comparable rate due to differences in calculation methodologies. The DIR is also the only one of the three elements which carriers regularly make public. However, carriers pass along both favorable and unfavorable mortality and expense experience in the dividend calculations. They just rarely disclose them except in internal documents. Carriers can maintain the DIR while the overall dividend declines on a policy due to the adjustments to the other dividend components.





Given the overemphasis on marketing the DIR, policyholders may mistakenly assume the DIR multiplied by the cash value will equal the dividend, but that is incorrect. The actual dividend growth will differ due to the expense and mortality elements. To illustrate that point, look at the following two graphs based on an inforce whole life policy. In the "Missing Cash Value Growth" graph, the dark bar[iii] indicates the actual illustrated growth in cash value on a policy with a 6% DIR. The gray bar[iv] indicates the amount of growth that didn't happen on the cash value because of the other dividend components. So, even though the DIR is 6%, the actual cash value growth is far less than that…even declining over time. In the "% of Cash Value Earning Dividend Interest Rate" graph[v], it simply calculates what amount of cash value earning a pure % would generate the illustrated cash value growth. The point of both is that you shouldn't become enamored with a high DIR or the history of the DIR. Contrary to how they may be marketed by some agents, the DIRs are not reflective of the actual net growth in cash value…just a portion of the overall dividend calculation.

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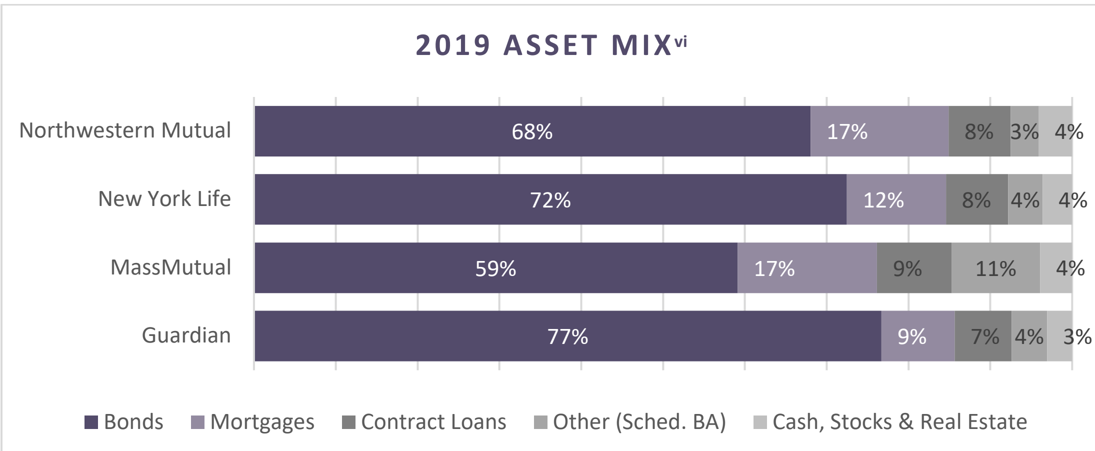
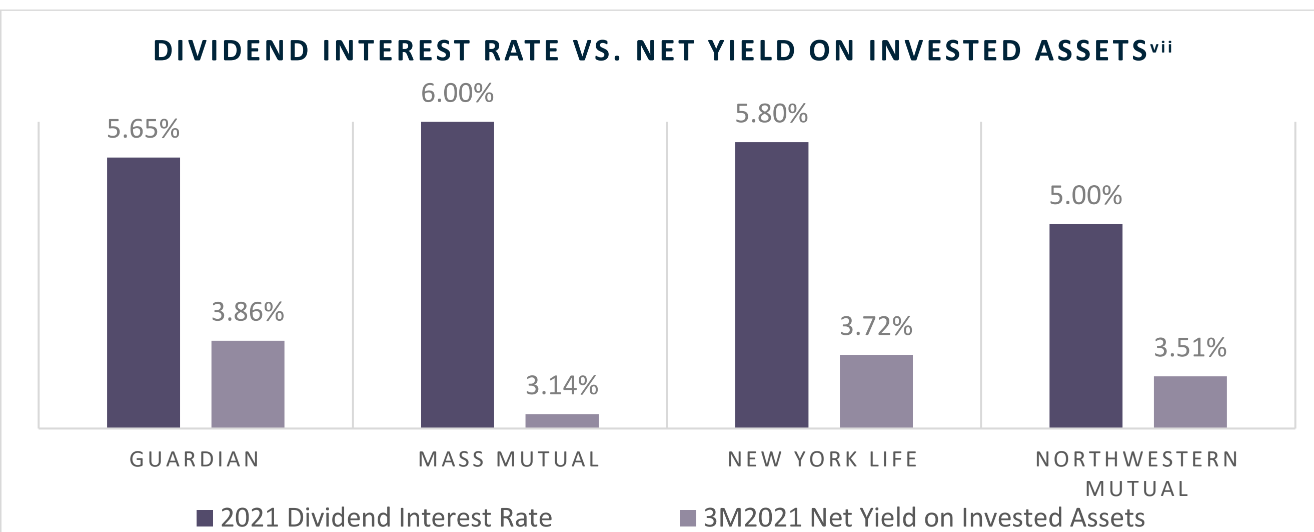
Interest Rates – The Elephant in the Room

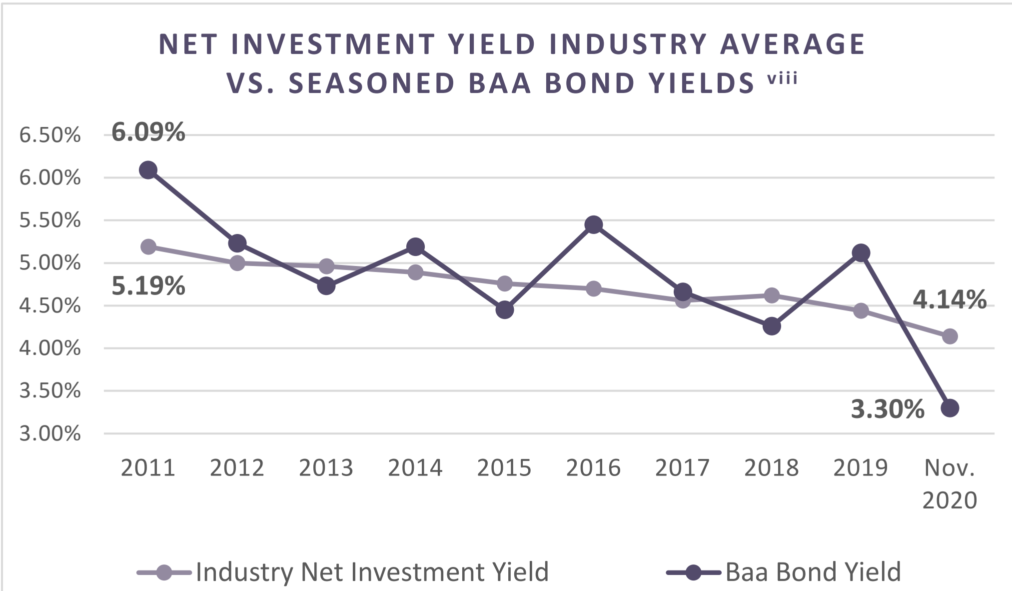
The DIR will be inextricably linked in large part to the assets a carrier invests in and the yields earned. The Asset Mix graph[vi] shows that between 76%-86% of carrier assets are invested in bonds and mortgages…assets driven by interest rates. As insurance regulators give more credit to satisfying capital requirements for lower risk assets, these bonds are mostly investment grade. Risky assets are counted at a fraction of their value which serves as an impediment to carriers seeking higher returns via higher risk. Asset/Liability matching is important for carriers too, so maturities are driven more by the liability timing than a quest for higher yields.



The yields on many assets have dropped precipitously in 2020. The annualized 1st quarter 2021 Net Yield on Invested Assets[vii] shows just how tough a year it has been.



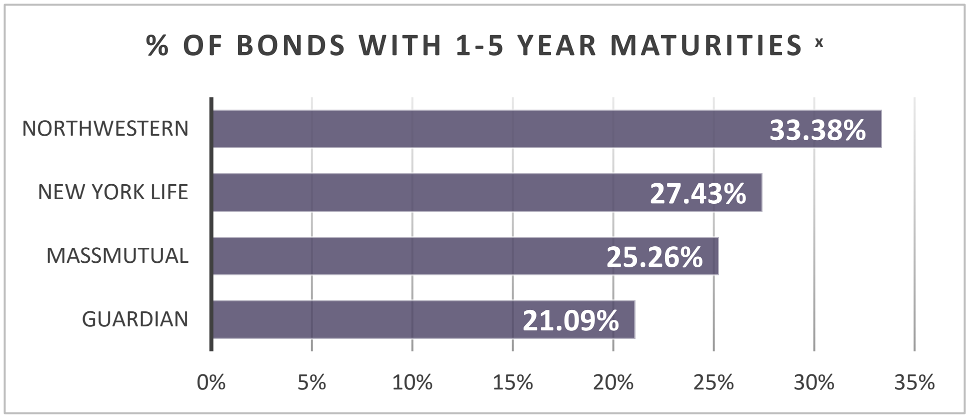
The entire life insurance industry is feeling the impact of declining yields. The graph below shows the average Net Investment Yield for the industry versus yields for Seasoned Baa Bonds[viii]. The Net Investment Yield declined 30 basis points to 4.14% (on an annualized basis) in the first 9 months of 2020.



A December 2020 paper from The American College of Financial Services[ix] discusses the myriad of ways interest rate declines impact carriers including product demand, revenue, capital reserves and even solvency. The article states "the products that are most exposed to the risks described are long-term contracts, especially those with investment or return guarantees such as annuities and certain types of life insurance, such as whole life, which promises a guaranteed payout". Japanese insurance companies have dealt with persistently low rates since the early 90s. Their reactions have been studied by US actuaries for years to learn how those carriers pivoted product offerings in order to thrive in the challenging yield environment. The paper references product shifts in Europe and the U.S. as carriers in those regions are forced to adapt and indicates "whole life products with their guaranteed returns have fallen out of favor".

Headwinds for Yields

In 2019, the primary mutual life insurance carriers held 21%-33% of bonds with 1-5 year maturities[x]. Several signs point to continued low interest rates for the foreseeable future. On December 16, 2020, the Federal Open Market Committee elected to leave the federal funds rate unchanged at 0.00%-0.25% while their median forecast for short term rates showed no hikes through 2023[xi]. In early December 2020, Bank of New York Mellon Corp. issued $750 million of three-year bonds at a 0.386% yield…the lowest ever for that maturity[xii]. In a September 2020 survey by the Society of Actuaries, the top concerns of carriers included reinvestment rates (81% of companies surveyed), new business yields (77%), and ability to support in-force guarantees/in-force margins (65%)[xiii]. Carriers are retooling new product portfolios in light of the expected yields with many carriers exiting business lines, pulling certain products from shelves, or raising premiums significantly. They don't have those same luxuries for giant books of in-force whole life policies with 4-5% embedded guarantee rates. Adjusting dividend payouts downward and increasing policy loan rates are logical avenues for addressing the dearth of yields to support high embedded guarantee rates. In fairness, all carriers are facing challenges with legacy books of business…not just whole life. Rates have impacted life policies, annuities, and long-term care policies with unbiased animosity.



Policyholder Takeaways

Accept Reality - The first thing policyholders must do is accept the economic reality that dividends will continue to face downward pressures for the foreseeable future. Ignore the disingenuous carrier marketing hype showcasing past dividend histories. Yes, carriers will pay dividends, but probably not as much as you want or as much as your policy may need. Don't bet on rising interest rates rescuing a struggling policy as the portfolio nature of the investments create a natural lag behind new money rates. Hope is not a strategy for a life insurance policy.

Become Vigilant - Far too often policyholders get a policy termination (lapse) notice and then a surprise tax bill due to policy premiums having been paid via a loan against the cash value. Others, who may get a premium notice requiring a higher premium, learn for the first time they have a blended product…not a pure whole life product. Don't let complacency or lack of understanding about your policy turn your policy into a nightmare. Policyholders would be well served to actively request reprojections of their inforce whole life policies (called an inforce illustration) to see how their specific policy may be impacted. It would be wise to request an illustration at both the 2021 dividend scale and another one assuming the DIR drops by a full percentage point (i.e., run at 6.00% and at 5.00%) to better understand the long-term implications on the policy of dividend fluctuations.

Plan for the Downside – A policy won't be harmed by increasing dividends, but it will by declining dividends. Plan for the downside by understanding how a policy will be impacted from downside events. This helps to avoid surprises, helps with budgeting for future premiums, and prepares for the possibility of future tough decisions regarding the policy. Don't sweat the upside…it will take care of itself…but it may be a very long time before it gets here.

Seek Advice – Policyholders likely don't understand how their policy works, so they need to get the advice of a competent agent who will be realistic about the existing product (not to mention any products they may offer). Don't feel beholden to the original agent if the policy isn't performing as expected. People change advisors from time to time whether a banker, accountant, investment advisor, attorney, or insurance agent. There may be viable solutions with the existing policy to achieve goals in the face of dividend headwinds, but policyholders seeing undesirable outcomes in the inforce illustrations may want to work with an independent agent to explore other non-whole life alternatives that could guarantee a specific premium outlay, lower the loan interest burden, avoid higher premium outlays, or offer better potential for growth in policy values.

In summary, whole life isn't a bad product, and dividend declines don't make a carrier bad. Declines are just economic reality. For decades, products of many types have had the flexibility to be structured with greater or lesser levels of risk depending upon the assumptions employed at the time of purchase (often unbeknownst to the policyholder). Whole life is no different. Some whole life policies won't skip a beat in the grand scheme of things while some structures are a train about to jump the tracks. It's up to policyholders to know which kind of product they own, but they probably need a little help along the way to navigate the mysterious waters of life insurance.

[i] Dividend Interest Rate information taken from carrier press releases in 2020 and 2021. Dividends Paid to Policyholders from S&P Global Market Intelligence carrier 2019 statutory financial data filings which was the most recent full year filing available at the publication date.

[ii] Dividend interest rate data taken from various carrier publications and sales material providing dividend interest rate histories.

[iii] Illustrated Cash Value Growth calculated as (Current year total cash value / prior year total cash value) -1

[iv] Missing Cash Value Growth calculated as 6.00% Cash Value Growth Rate - Illustrated Growth in Total Cash Value. This value is useful to remind consumers that the DIR should not be viewed as a net growth expectation on policy cash values.

[v] (Growth in Total Cash Value/Dividend Interest Rate)/Prior Year Total Cash Value

[vi] S&P Global Market Intelligence carrier statutory financial data filings

[vii] S&P Global Market Intelligence carrier statutory financial data filings. Note that the Mass Mutual numbers are likely skewed lower by capital from past divestitures that hasn't yet been fully deployed into new investments.

[viii] ALIRT Insurance Research – US Life Insurance Industry Review Nine Months 2020

[ix] "Lower Rates for Longer: What Does Fed Policy Mean For The Life Insurance Industry", The American College of Financial Services® December 2020

[x] S&P Global Market Intelligence carrier 2019 statutory financial data filings

[xi] December 16, 2020: FOMC Projections materials, accessible version www.federalreserve.gov

[xii] "Demand for Corporate Bonds Drives Inflation-Adjusted Yields to Zero, The Wall Street Journal, Dec 7, 2020

[xiii] COVID-19 Update: Economic and Asset Impact, September 30, 2020 Society of Actuaries®