PREMIUM FINANCED UNIVERSAL LIFE

A DURATION MISMATCH

wealtra

INTRODUCTION

On the 18th February 2024, the Hong Kong Insurance Authority's acting head of long term business, quite rightly, published an article entitled "Beware of risks related to premium financing". This is not their first warning shot, having jointly with the Hong Kong Monetary Authority issued guidance to the insurance related industry in 2022, and applying new supervisory requirements on the insurance sector which came into effect in 2023.

The message, albeit somewhat after the horse has bolted, is that utilising short term financing to fund long term liabilities (Universal Life policies often being written to age 100 of the life assured), is an extremely hazardous pursuit.

Having personally started in financial services in 1987 in the UK, one month before the market crash in October that year, I have vivid memories of the disastrous connectivity between banking and life insurance over the years. When one combines banking, with life insurance and the delicate (from a regulatory point of view) private client, one nearly always ends up with an explosive mixture which can be fatal for the unwary.

Let me explain.

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Insurance Companies are Delicate...

In 1985, when I left the British Army, I elected for a "Sales and Marketing" resettlement course. The penultimate week was spent with an insurance company called Confederation Life Insurance Company, a Canadian insurer, founded in 1871. Notwithstanding their obvious angle of seeking to employ ex-military officers as sales agents, at the end of that week I was told that I was wholly unsuited to the life insurance industry, and they would not offer me a job. Quelle horreur!

Fast forward to 1994, and Confederation Life was forced into liquidation with its real estate portfolio falling precipitously in value leading to a collapse in its assets, and I had just moved on from my job in the City of London, where I had become a financial advisor and the top revenue producer, with about 40% of my revenue coming from... life insurance! Never judge a book by its cover!

Confederation Life was not the only victim, with at least 3 other Canadian insurers going into liquidation during that period.

The demise of these insurance companies in Canada was superseded in tragedy (at least to a Brit) by the demise of Equitable Life of the UK which closed to new business in 2000, and subsequently went through a painful "death" resulting ultimately from the mismatch of its assets with Guaranteed Annuity Rates that it applied to some of its policies.

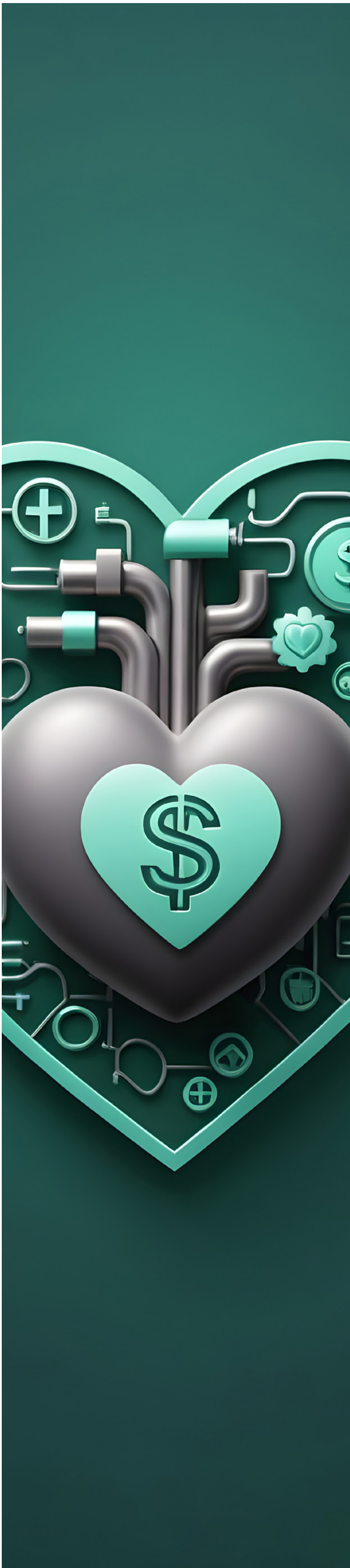
The moral of the story is that life insurance companies play a delicate balancing act between assets and liabilities (and duration), and when a structural change in the economic environment takes place, and when prior assumptions turn out to be mistakes, the mathematics can go horribly wrong, with the assets not match the liabilities.

...and so are the Brokers

Coincidentally, my connectivity to mishaps in the insurance world extends further. After my brief flirtation and rejection by Confederation Life, I started in financial services in 1987 with a firm called Towry Law, which was based in Windsor next to the castle, and employed mainly ex-military officers.

Towry Law was a financial advisory firm, and had an international arm called Towry Law International (TLI), and during the heady bull market of the later 1990's TLI grew rapidly. One of the pillars of this growth was the selling of single premium with-profits funds on a premium financed basis (some to expats based in Hong Kong and Singapore where TLI operated). Post the market collapse of 2001/2002, many investors sought to surrender these bonds as they could no longer afford the financing costs (having lost their jobs), and whilst they had been sold the funds as secure low risk investments, they were not aware of the small print of the policies whereby the insurance company could apply a "Market Value Adjustment Factor" (MVA) to the policy value to offset any falls in the assets backing the policies.

Of course, the assets backing the policies had fallen dramatically, and MVAs of over 20% were applied to the policies leading to policy owners who needed liquidity suffering even more severe losses due to leverage.



...and do not forget the banks...

Whilst I have highlighted above the potential risks associated with the insurers and the brokers (ultimately impacting the policyholders as private individuals), the banks have to be highlighted for their enormous exposure and misconduct when associated with insurance and financing.

Again, in the UK, the involvement of banks in the mis-selling of payment protection insurance ultimately cost them over £50 billion, whilst as I write, in February 2024, the Financial Conduct Authority in the UK is investigating the banking industry's involvement in motor financing deals, which is likely going to require them to make provisions for as much as £16 billion in compensation claims.

The moral of the story (so far) is that risk management is key when developing an insurance strategy, with an understanding of the credit risk of insurers being paramount and the use of leverage being something to be very weary of, whilst understanding the complexities of the policies being essential to understanding the complete risk matrix. Finally, it is vital to ensure the interests of the parties involved in the advice and selling of the insurance are aligned with the private client and that suitable advice is given and that the client understands that risk.

So where do the risks of premium financing of Universal Life Insurance lie?

Premium Financed Universal Life – The Risks

The Hong Kong Insurance Authority has clearly identified significant risks which are now emerging in the insurance and related sector in Hong Kong resulting from premium financed life insurance activity (which may not be solely attributable to Universal Life). So, what are these risks likely to be?

1. Firstly, there is the obvious funding cost risk. Billions of dollars in premium income to life insurance sold in Asia in the last 15 years or so, resulted from the artificially low interest rate environment that persisted for much of the time. With Libor as low as 0.25%, with a lending spread of (say) 0.75%, investors were able to source extremely low funding costs for premiums (more later on this) of around 1%. Free money!

   At the time of writing (February 2024) the current Libor equivalent, the Secured Overnight Funding Rate (SOFR) is 5.31% - add 0.75% to that and cost of funds is over 6%. Very expensive "free" money!

2. Secondly, many entering premium financed universal life did so because they thought they had discovered a significant arbitrage opportunity. That is the difference between the funding cost and the crediting rate of the insurance company. However most did not understand that the applied crediting rate does not reflect expenses such as the cost of insurance and administration expenses. So, one would have to look at the credit rating less the expenses to see if there was any real arbitrage. There is no free lunch!

3. Thirdly, the General Account of most insurance companies

is invested heavily into bonds, and when a crediting rate is applied to a group of policies, this risk needs to be hedged with investments backing that crediting rate. In order to hedge, the insurance company needs to go long on duration on its bonds. The result is that when interest rates fall, and especially when they rise, there can be a significant lag between the movement in volatile short term interest rates (the funding mechanism in premium financing), and the crediting rate of the insurance companies. The result is eventually a significant mismatch which can hurt badly when short-term interest rates rise, as they have now done – the duration mismatch.

4. Fourthly, the sacred mantra of insurance is it needs to be sold rather than bought. That is to say that people do not wake up with an enormous desire to buy life insurance, which means that the acquisition cost to the insurer is very high due to the additional efforts and inducements required to persuade the client of the benefits of insurance in meeting their financial goals.

   The challenge here is that to induce sales, large commissions are often associated with life insurance (an expense against the crediting rate). The result is that whilst there are many valid reasons for the use of life insurance in a financial plan, there is an increased risk of mis-selling when there are high commissions involved. This risk is multiplied considerably when premium financing is involved. Often lenders would lend up to 95% (or more in some cases) of the initial surrender value of the policies. With commissions alone, of around 12-15% of the premium, this in effect equated to nearly 100% of the cash element put down by the client. The point here is that when inducements are high, there has to be a much higher standard of care applied to ensure, in particular where unsophisticated investors are concerned, that policies are not mis-sold, and that all operators in the supply chain closely adhere to a strict protocol of explanation and disclosure. Hence the HK Insurance Authority concerns.

5. Finally, there is of course the risk to the insurance companies. If a significant percentage of the insurance companies general account premium income has been from premium financed policies, the insurance companies themselves are sitting on a large amount of (off balance sheet) leveraged assets. If the asset quality of their General Account has deteriorated (as bonds have done on the last few years, especially High Yield and Emerging Market bonds), and policy holders are forced to deleverage and surrender their policies (at the guaranteed surrender values contractually offered by the insurance companies), then this could create significant problems.

6. Finally, many Universal Life policies were sold without a Guaranteed Death Benefit – that is if the crediting rate was not sufficient to meet the policy expenses in the long term, the cash value might not be sustained sufficiently to maintain the death benefit, and

the policy could lapse unless further payments were made or the sum assured reduced).

Action Creates Reaction

Whilst there are numerous other risks to the policyholder, the above highlights the risks that are immediately apparent. Investors who used leverage in the last 15 years or so, when their starting point was an artificially low interest rate, are now faced with an extreme spike in their funding costs. Furthermore, the investor who might have leveraged to pay a premium for their life insurance policy, is also likely to have other loans (mortgages, business loans etc.) which are also causing considerable pain.

For the very high net worth client, assuming strong cash flows and additional liquidity, they are likely to opt to deleverage, unless they are confident that they can achieve a compound rate of investment return on their other assets of more than the funding rate – a dangerous and speculative approach. Typically, they would hopefully have assets which can be liquidated to pay down the financing that was undertaken – clearly this has a considerably negative effect on the calculations that may have initially drawn them into premium financing.

Many policyholders, especially those in the mass affluent segment without significant alternative liquidity, may be forced to surrender their policies.

The mass affluent segment is probably where the HK Insurance Authority is most concerned. If a few rich people lose some money, then there is not a problem – it is when large numbers of mass affluent citizens lose money that more of a problem occurs. Indeed, according to the recent Insurance Authority article, whilst the Insurance Authority received 28 complaints on premium financing in 2022, this has increased to 50 in 2023, and is almost certainly going to increase further in 2024 as high interest rates persist. The main issues with these complaints were a lack of disclosure of risks by intermediaries and the misrepresentation of information such as policy terms and loan rates.

In the HNW and UHNW segment, risks nevertheless prevail, and it is these clients who, should they have grounds to attack, might try litigation as a remedy for their poor decision making.

Conclusion

On a positive note, the use of life insurance in a client's financial plan still plays a significant role. However, the days of free money are over, and were only ever going to be temporary) and the industry is adapting accordingly. Multi-pay policies are coming into their own, whilst premium financing of policies is collapsing. According to the HK Insurance Authority, premium financing activity has slowed down substantially, with a 43% share of total market in 2022, to 21% in 2023 (with a multi-year record low of 9% in the 4th Quarter of 2023).

The main message to the brokers, supported by the insurers and the wealth planners at the banks who helped distribute the policies and provided the financing is that we are probably in a critical period of ensuring that the risk faced by policyholders does not flow over into a greater risk for the industry as a whole. Policyholders who are facing difficulties will need significant oversight and advice on how to manage the current environment, and the varying institutions in the supply chain need to make sure that they are following the regulators recent guidance, and indeed they need to ensure that their records support their previous engagements with clients.

Furthermore, regulators in other jurisdictions that have not followed the HK Insurance Authorities diligence need to take a proactive role in insuring that the participants in the life insurance related sector are stepping up their diligence and helping their clients who are experiencing difficulties. The problem of course with policies which pay a significant up-front commission is that the participants in the supply chain are not motivated to spend too much time on servicing clients who have already been sold policies – and yet now is likely the time that many do need help and guidance. This will be particularly important to those banks that have been financing the policies, and to the Trustees who have in many cases become the owners.

The risk to the brokers, insurers and banks (and Trustees) is that if the historical premium financed business is not looked after well, the problem could escalate, and the last thing we need is a repeat of the problems experienced in the UK and Canada, 30 plus years ago.