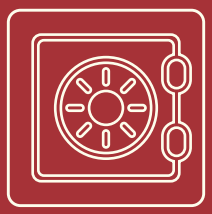
JUST HOW SAFE IS AN **INSURANCE COMPANY** *REALLY?*

AN INSIDE LOOK AT THE INSURANCE INDUSTRY AND THE REGULATIONS THAT KEEP IT IN CHECK



When you think about the car you drive, the house you live in, the health plan you use and the life insurance policy you have, it's not a stretch to say insurance is an intrinsic part of our daily lives.

The insurance industry is also one of the most heavily regulated industries in financial services. That's an important point to keep in mind, especially when you hear about an insurance company in distress.

Still, it's appropriate to question just how safe insurance companies really are, particularly for today's retirees and people nearing retirement. Here, we will look at the basic workings of an insurance company and then review the safeguards in place to regulate the industry.

HOW INSURANCE WORKS

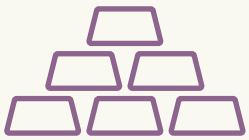
Let's start at the top; all the guarantees and promises insurance companies make are backed by the financial strength and claims-paying ability of the issuing carrier. Every insurance company (or "carrier") is overseen by the insurance department of the state it is headquartered in, or its "domiciled state." This state is always responsible for the primary oversight of the carrier. If the carrier also wishes to do business in other states, it must apply for a license in each one and be approved by each state to conduct business there. These additional states may then also assist the primary state in its oversight of the company.

To help ensure consistency in the standards of oversight across the country, state regulators come together under the National Association of Insurance Commissioners (NAIC). The NAIC is a regulatory support organization governed by the chief insurance regulators of all 50 states, the District of Columbia and five of the U.S. territories. The NAIC:

- Helps state regulators develop and coordinate state oversight of insurance carriers
- Helps to develop model laws, which are then adopted by individual states as their framework for insurance regulation to create a consistent oversight model across the country
- Assists with setting sales and advertising standards within the states

So when it comes to regulatory oversight, what exactly is a state insurance department looking for? The department's responsibilities include monitoring the market conduct of the carrier in its advertising and interaction with consumers, reviewing insurance products for approval to sell in that state, and ensuring the carrier's adherence to all laws of that state regarding running an insurance company. But the most important part of the state's oversight is to ensure the insurance company can meet all of its financial obligations and pay all of the claims it has made to its policyholders.

THE IMPORTANCE OF RESERVES



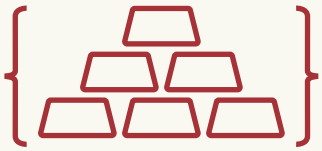
To ensure that an insurance company will maintain the ability to pay claims and meet all other financial obligations, it sets aside (or "reserves") a portion of the money it receives from the sale of each insurance product. This money is earmarked specifically for the purpose of paying the insurance company's obligations.

Most of these reserves are invested in financial assets such as bonds or cash. This sounds simple, but the reality is much more complicated. Why? Because insurance companies must predict what will happen in the future in order to maintain the necessary funds in their reserves.

Remember, a carrier takes in money today to pay claims out tomorrow. Many factors may affect how much money needs to go into the carrier's reserve system, and many issues must be taken into account with the sale of each product. For annuity products, some of the variables carriers must consider include:

- What is the probability a consumer will let his or her policy lapse?
- If that doesn't happen, when will the consumer start taking his or her income if he or she has that option?
- If there are other options, like long-term care, what is the probability of the policyholder using that option?
- How long is the consumer likely to live?
- What type of investment yield will the carrier earn?

GUIDELINES ON INVESTING RESERVES



Strict guidelines govern how carriers can invest the money they receive from the insurance policies they sell. These guidelines, which come from and are enforced by the state, based on the NAIC guidelines discussed previously, create parameters on investment categories (such as corporate debt, government debt and asset-backed securities). The parameters also limit how much money can be invested into each category to limit the concentration risk.

Given these parameters, the majority of investments insurance companies make are in highly rated government or corporate bonds. According to a 2018 Capital Markets Special Report from the NAIC, bonds were the largest component of U.S. insurance carriers' assets, representing 65% of total cash and invested assets as of year-end 2017.[1]

So to recap: The carrier takes money from the sale of a policy, invests the money in a variety of investment products and then reserves a portion of those investments specifically for the purpose of paying all future obligations. All of this is done within the parameters of the insurance department in the insurance company's domiciled state and in coordination with the NAIC to ensure consistency in standards across the industry.

REGULATING THE RECORD-KEEPING

In addition to regulating an insurance company's reserves, state insurance departments oversee the record-keeping of the insurance companies domiciled in their states.

Each insurance company must submit its annual financial statement to the state insurance department (and every state that it is licensed to do business in) by the end of February of the following year. This annual report is an exhaustive look at all of the carrier's financial information, including all investments held, as well as what business is written, what states it is written in and many other details.

The amount of information that the state and the NAIC require from the carrier may make this annual report hundreds of pages long. In fact, it's similar to the document a publicly traded company must submit to its policyholders annually. If you wish to see this document, you can request it from the insurance department of the carrier's domiciled state, or access it directly on the insurance department's website.

On top of the annual report, the carrier must submit its financial statements quarterly as well. While not as comprehensive, these reports contain a significant amount of financial information and can be very helpful in understanding the health of the organization.

To ensure the carrier is adhering to the conforming audit and control standards annually, each carrier is audited by an external auditor. The auditor conducts a full financial audit of the carrier's books, records and the reporting controls in place around them. The auditor then reports to the state insurance regulator on whether the insurance company is accurately performing and recording its financial information, including all of the reserve testing described in the next section. In addition, the state insurance regulator will perform an on-site financial audit on a regular basis.

CALCULATING CARRIER RISK

Each year, an insurance company also must run what is referred to as a "cash flow test." This test considers all of the carrier's current, in-force policies and all of the investments it holds and then projects whether the carrier will have sufficient assets to pay all of its liabilities and obligations. The carrier must then submit its test to the state insurance regulator for review as well.

To help determine the amount of risk a carrier actually carries and how much it should hold in capital — or the investments the owner(s) of the company have put into the business — each state performs a series of calculations known as a "capital adequacy test." This test results in a minimum capital (owner's equity) an insurance company is required to hold. An insurance company looks to hold multiples of that minimum capital level. (A rule of thumb is six to eight times a state-based minimum.)

To calculate this minimum capital level requirement, the state insurance regulator evaluates how much risk each aspect of the company carries. The NAIC has worked with the state insurance departments to develop a consistent formula used to determine this number. This formula looks at all of the investments and liabilities of the carrier as well as any other business risks to ensure that the amount of capital held by the insurance company is sufficient.

This truly comprehensive calculation takes into account every invested asset and is a significant undertaking for an insurance company to complete. If the capital adequacy test falls below a certain level, the state is required to take action to make sure the carrier adjusts its capital accordingly.

FINANCIAL STRENGTH RATINGS

In addition to the reviews and oversight performed by the state insurance department, each insurance company is given a financial strength rating by a nationally recognized statistical rating organization, or NRSRO, such as A.M. Best, S&P, Moody's, Fitch, etc. The U.S. Securities and Exchange Commission strictly regulates which credit rating agencies can be registered as an NRSROs.

The credit rating agencies conduct an independent review of the carrier and its operations, taking into consideration all macroeconomic and industry trends. If the agency provides a rating for the carrier, it will also annually publish a credit and financial strength rating and write-up. You can find these ratings on the agencies' websites, and they can typically be found on the website of each insurance company, too. If necessary, the credit rating agencies will publish an interim release reporting any news obtained between review periods that could affect a carrier's rating.

WHEN SOMETHING GOES AWRY

Even with all of these checks and balances, there are situations in which a carrier may find it has underestimated its financial obligations, and the carrier's state insurance department needs to step in. This typically happens when the obligations of a company continue to grow disproportionately to the growth of its reserves — in other words, the financial assumptions the carrier made about the future proved inaccurate.

If the company does not have the necessary capital to meet its obligations, the state may need to take control of the company. When that happens, the state insurance department works with other state regulators through the National Organization of Life & Health Insurance Guaranty Associations, or NOLHGA, to get payments from other U.S. insurance carriers to meet the deficit.

The good news is defaults in the insurance industry are extremely rare. In fact, the insurance industry remained largely immune to the severe hardships that shook the financial industry as a whole in 2008. That was due in large part to the regulatory system and rigorous oversight in place in the industry.

TAKE A 360-DEGREE VIEW

When you consider the substantial layers of protection that apply to insurance companies, you can understand why they are considered to be safe financial institutions. While no single financial vehicle is appropriate for every situation or for every consumer, today's well-rated insurance companies often can serve a valuable role in financial strategies.

[1] Michele Wong. National Association of Insurance Commissioners. Aug. 16, 2018. "Capital Markets Special Report: U.S. Insurance Industry's Cash and Invested Assets Rise 5.1% in 2017." https://www.naic.org/capital_markets_archive/180816.pdf. Accessed April 3, 2019.

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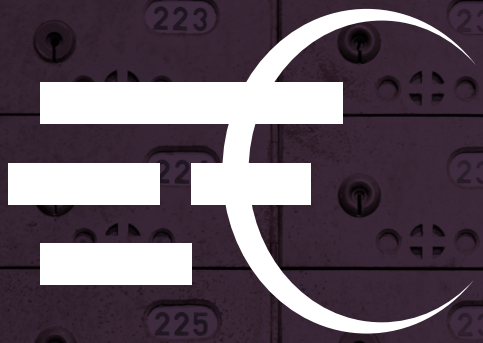

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