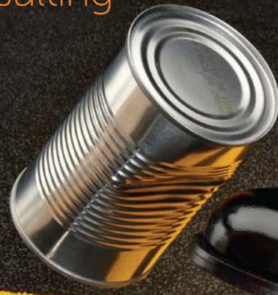

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2022: ANOTHER YEAR OF KICKING THE LOW INTEREST RATE CAN DOWN THE ROAD, OR NOT?

Perspectives on 2022 Dividend Interest Rates When It Comes to Whole Life Policies

By Tom Love, CLU®, FLMI®

Today, most whole life sales come from four large mutual companies: Northwestern Mutual, New York Life, Mass Mutual, and Guardian. All four companies actively market dividend "scales" between 5% and 6%. The dividend scale refers to a single element of the dividend formula—the Dividend Interest Rate (DIR). However, this does not mean that the cash value earns 5% or 6% cash on cash… the interest component of the dividend formula uses this rate along with other elements including mortality experience and other expenses. The easiest way to understand this concept is to look at the 2020 statutory filings showing whole life dividends and whole life cash value.

Carrier	Whole Life Dividends	Whole Life Cash Value	WL Dividends / WL Cash Value
Guardian	$1,033,485	$35,842,665	2.88%
Mass Mutual	$1,375,068	$62,540,138	2.20%
New York Life	$1,822,609	$70,713,521	2.58%
Northwestern Mutual	$5,249,102	$153,823,623	3.41%

Note: Dividends and Cash Value are in $000's.

The 5%-6% DIRs being marketed are well below investment grade bond yields being purchased today (as well as the last few years). We will touch on this more later. The key question we seek to answer in this white paper is, "What level of dividends can clients expect moving forward?"

With carrier investment yields continuing to decline along with historically low bond yields, DIR announcements deviated between mutual companies mostly holding the DIR steady and non-mutual companies reducing DIRs.[i] Prudential's large values are paid on inforce policies, since the company does not actively sell new whole life. *(Note: Carrier statutory filing data for 2021 will not be available until end of March 2022.)*

Carrier	2022 Dividend Interest Rate (DIR)[i]	2022 DIR Change	2020 Dividends Paid ($000s)[i]	2019 Dividends Paid ($000s)[i]
Northwestern Mutual	5.00%	0.00%	6,234,879	5,998,860
New York Life	5.80%	0.00%	1,962,873	2,043,187
Mass Mutual	6.00%	0.00%	1,697,381	1,671,109
Prudential	[a]	[a]	1,382,781	1,570,722
Guardian	5.65%	0.00%	1,035,925	967,943
Metropolitan Life Ins Co[b]	3.80% to 5.85%	0.00% to -0.50%	22,977	133,113
Ohio National[c]	4.00%	0.00% to -0.70%	105,865	112,994
John Hancock[d]	2.50% / 4.25%	-0.75% / 0.00%	91,848	109,996
Penn Mutual	5.75%	0.00%	108,927	98,433
Brighthouse Life Ins Co	4.00%	-0.35%	4,819	5,103
New England Life Ins Co	3.80%	-0.50%	3,610	4,052

[a] Prudential doesn't disclose the DIR but announced a continuation of the 2021 dividend scales for 2022. However, the expected payment of $1.3 billion in 2022 was $100 million less than the $1.4 billion expected payment in their 2021 announcement. Virtually all policyholder dividends are paid in policies under Prudential Legacy Insurance Company of New Jersey.
[b] Metropolitan reduced the dividend scale for its "closed block" of policies from 0.25% to 0.50%
[c] Ohio National reduced dividend on its "open block" from 4.70% to 4.00%. The open block is policies issued on or after 8/1/1998.Ohio National was acquired by Constellation Insurance Holdings, Inc. in 2021.
[d] John Hancock reduced the DIR for policies issued prior to 2/1/2000. They also announced mortality changes but without any specifics.

For carriers not actively offering whole life, their reductions reflect the low interest rate environment. For carriers positioning whole life as their flagship product, the lack of reduction is likely a reflection of marketing concerns vs. economic circumstances. Congress passed a law in late December of 2020 that allowed whole life carriers to reduce guaranteed interest rates on new policies as low as 2%, whereas previously the law required a minimum 4% rate. This was a big win for carriers, but a loss for consumers who enjoyed the high guaranteed cash values. In late 2021, carriers released new products based on these new regulations, but with little insight into how the competitive markets may affect the contracts. It would not be a good look for the carriers to issue these new, "more competitive" products and then immediately reduce dividends.

WHAT IS WHOLE LIFE AND WHY DO DIVIDENDS MATTER?

Whole life, developed in the 1830s, is the oldest form of life insurance. Basic whole life offers a fixed premium based on conservative assumptions so that the guaranteed cash value equals the policy's death benefit at policy maturity. To the extent the company does better than these assumptions, it may pay a refund to the policy called a dividend. A common variation on basic whole life uses a combination of whole life, term insurance and paid-up additions (a.k.a. "blended") to reduce initial premiums but exposes the owner to the risk of higher premiums if dividends don't pan out as expected. Products are sold mostly though career agents, but New York Life and Mass Mutual also market their products through select independent firms like those at Valmark.

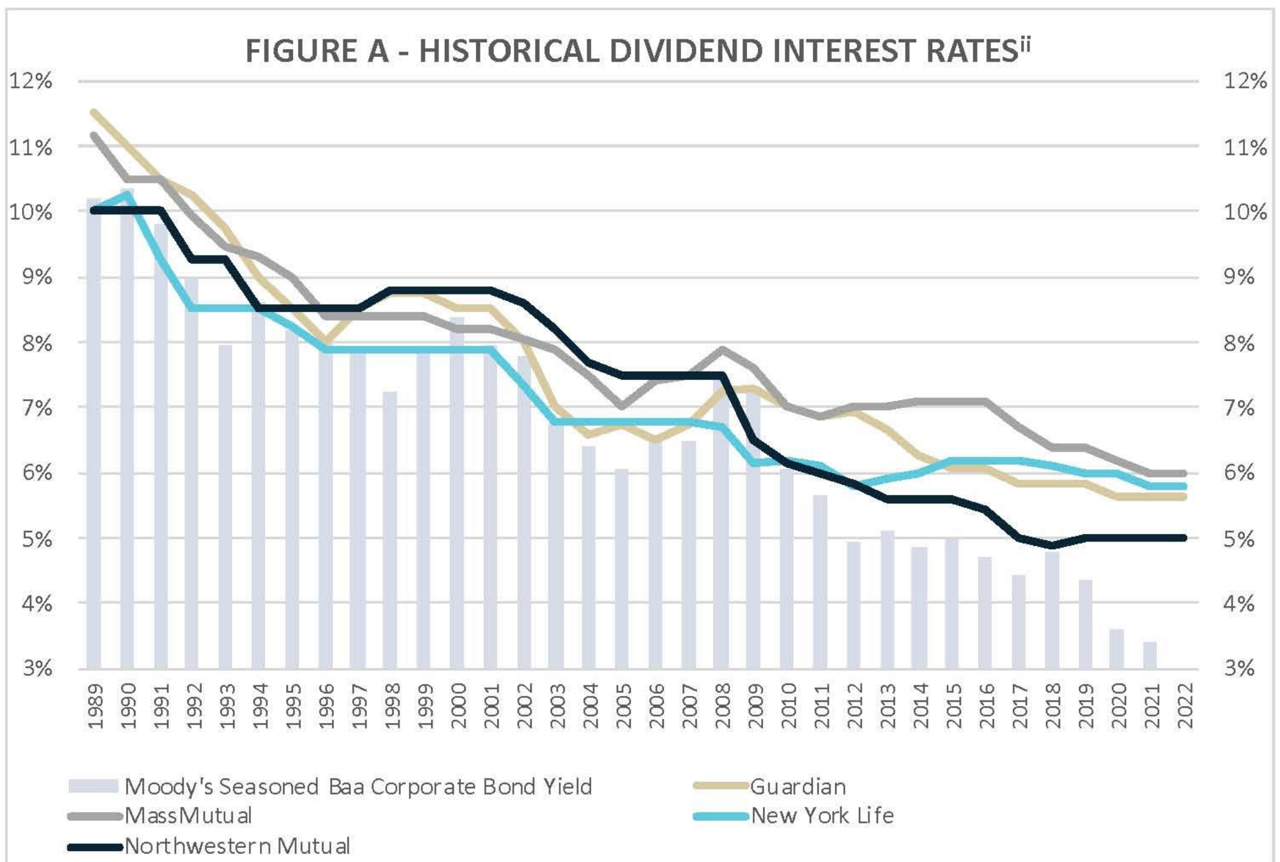
Dividends are a key factor in the ways consumers utilize whole life today. Dividends are commonly used to buy paid up additions (additional protection) or reduce out of pocket premium outlays. Lower dividends on whole life may cause:

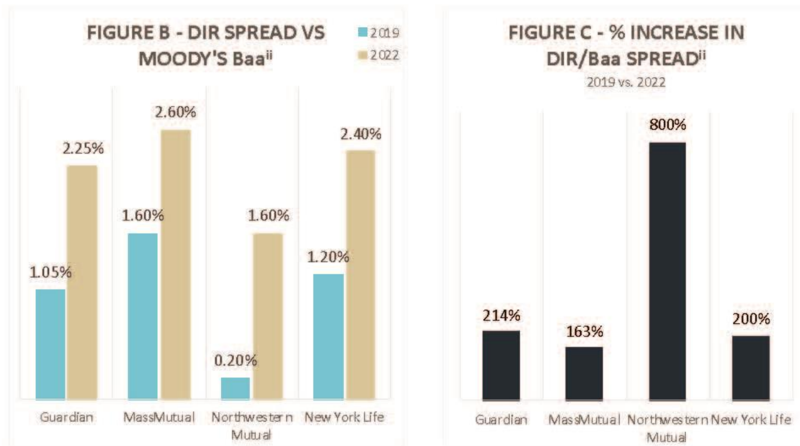
- Policy termination
- Lower cash value
- Lower death benefit
- Higher out of pocket premiums
- Reappearing premiums
- Inability to borrow future premiums

Blended policies, policies with loan balances, or policies using dividends to reduce (or stop) premiums are more dependent on dividends and thus more exposed to downside risk from dividend declines. With the reductions in dividends over the past few decades, whole life policyholders need to request inforce illustrations to determine the impact on their policy.

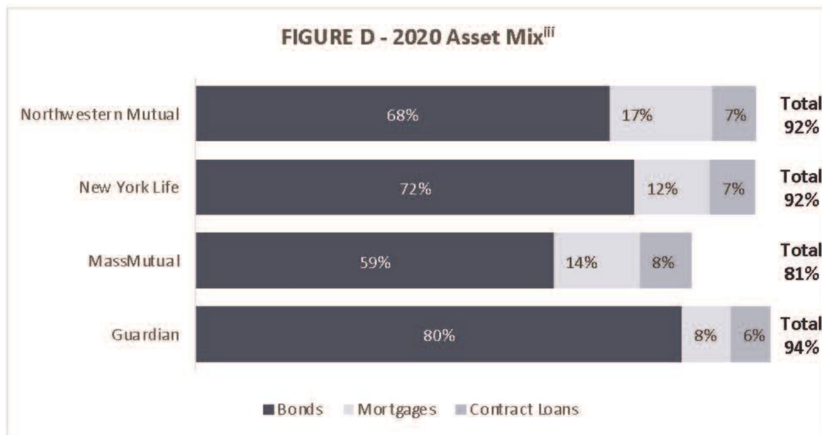
INTEREST RATES: THE ELEPHANT IN THE ROOM

DIRs have generally been declining for decades (see Figure A). The movement has generally tracked with Moody's Baa bond yields until recent years.[ii] The four carriers shown in Figure A have all maintained dividend rates much higher than the bond yields that support them. However, the gap has been growing significantly (see Figures B and C). The disconnect between dividends and economic reality for several years could be an indicator that a change is long overdue. How long can a carrier kick the can down the road? That is the question that should be on the minds of policyholders.

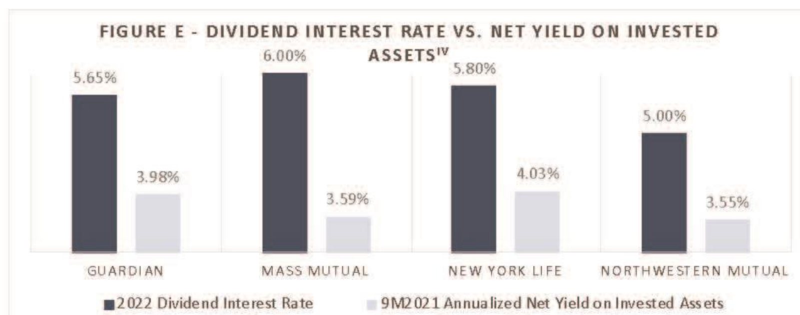




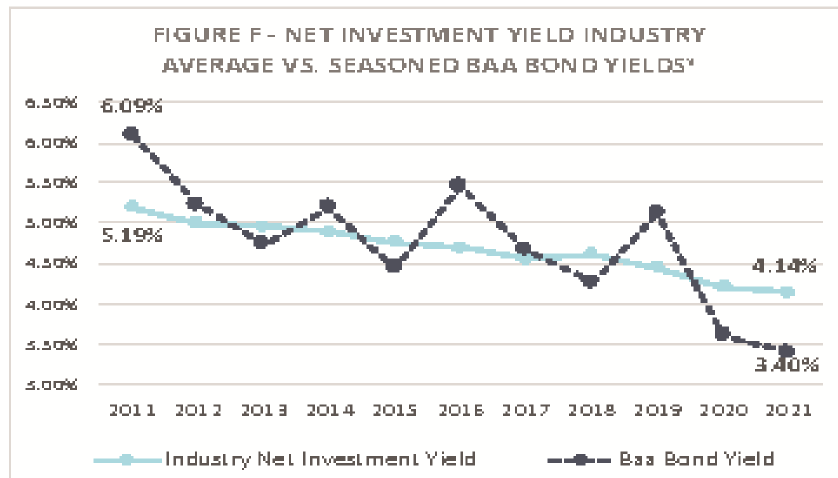
The DIR is inextricably linked in large part to the assets a carrier invests in and the yields earned. The Asset Mix graph[iii] in Figure D shows that three of the four whole life carriers listed have at least 92% of assets invested in bonds, mortgages, and contract loans, all of which are driven by interest rates. MassMutual is the lone outlier, but still has 81% of assets invested in instruments 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 continued to drop in 2021. The annualized third quarter 2021 net yield on invested assets[iv] (Figure E) shows just how tough a year it has been.

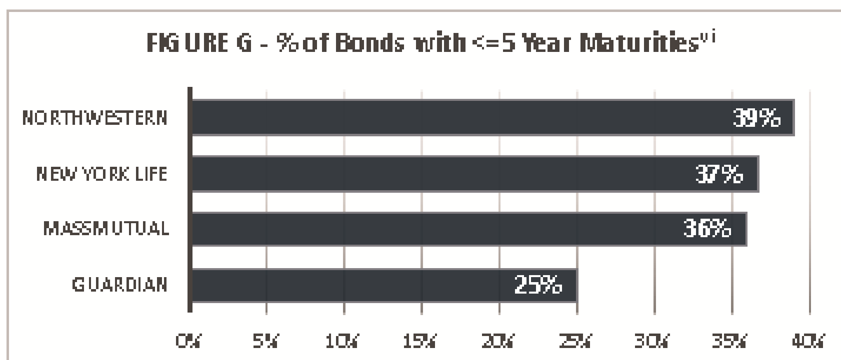


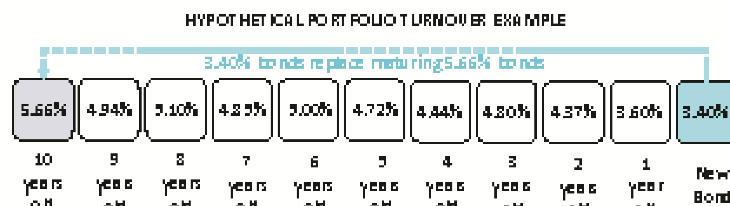
The entire life insurance industry is feeling the impact of declining yields. Figure F shows the average net investment yield for the industry versus yields for Seasoned Baa Bonds.[v] The net investment yield declined to 4.14% (on an annualized basis) in the first nine months of 2021.



HEADWINDS OR TAILWINDS FOR YIELDS?

In 2020, the primary mutual life insurance carriers held 25%-39% of bonds with maturities of five years or less[vi] (see figure G) with an average of just under 7% of that in bonds with maturities of one year or less. In 2022, the Federal Open Market Committee is expected to increase the federal funds rate. Since DIRs are tied to a portfolio of investments, rather than simply new money rates, any increases will take years to increase the overall portfolio yield. It is important to recognize that an increase in rates doesn't mean new bonds being purchased will have a yield greater than the maturing bonds being replaced. In the example below, a maturing bond issued 10 years ago yielding 5.66% may be replaced with a new bond yielding only 3.40%. Most bonds issued prior to 2019 that mature in 2022 will likely result in a reduction in yield. It is going to take several years of interest rate increases to flip the economics of maturing bonds to the degree that carrier portfolio yields materially improve.





COVID MORTALITY IMPACT

It's important to remember that dividends also reflect mortality experience. When mortality experience is better than expected, it may boost that element of the dividend calculation. Of course, the opposite is true as well...worse mortality experience could cause a drag on the dividend calculation. COVID has adversely impacted recent mortality results for the industry. A January 2022 report from the Society of Actuaries[vii] report noted the following key points:

- The highest increase (16.8%) in overall age-adjusted mortality rate dating back to 1900.
- When COVID deaths are removed, all other CODs (Causes of Death) combined increased mortality by 4.9%, the highest rate since 1936.
- External CODs including assaults (35.9%) and opioid overdoses (61.2%) had extreme increases in those ages 15-24.
- Excluding COVID, both males and females ages 15-44 had double-digit percentage 2020 mortality increases.

COVID has longer term implications as well which will become known only as time passes. COVID has hampered early detection of diseases such as cancer due to delays in seeking treatment. Will "long-COVID" prove to have detrimental effects on mortality over time due to damage to various organs including the heart and lungs? Will COVID cause people to focus more on exercise to reduce the co-morbidity risk or cause more people to engage in riskier behaviors or lifestyle choices because of the psychological and emotional strain of COVID? If mortality results are worse than expected in current dividend calculations, it could be another headwind for dividends.

KEY TAKEAWAYS FOR POLICYHOLDERS

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. Recognize that COVID could hamper the mortality component of the dividend in future years. 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 and 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 2022 dividend scale and another one assuming the DIR drops by a full percentage point (i.e., illustrations that run at 6.00% and at 5.00%) to better understand the long-term implications on the policy from 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 avoid surprises and allows budgeting for future premiums while preparing for the possibility of future tough decisions regarding the policy. Don't sweat the upside, it will take care of itself. However, it may be a very long time before it gets here.

Seek Advice – Policyholders likely don't understand how their policy works. They need 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 it be 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. Dividend declines are just an 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 2020-2022. Dividends Paid to Policyholders from S&P Global Market Intelligence carrier statutory financial data filings. Statutory data for 2020 was the most recent full year filing available at the publication date of this document.

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

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

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

[v] ALIRT Insurance Research – US Life Insurance Industry Review Nine Months 2021

[vi] S&P Global Market Intelligence carrier 2020 statutory financial data filings

[vii] U.S. Population Mortality Observations Updated with 2020 Experience January 2022 published by the SOA Research Institute www.soa.org

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