LIFE INSURANCE

The major distinguishing feature of the life insurance industry is its inherent long-term nature. The perspective of the long-term, collecting premium for many years and then paying a death benefit, impacts the approach to investing, revenue and expense recognition and regulation. The long-term nature of coverage combined with the increased risk of death as people age is distinct from the risks of other types of insurance.

Traditionally the life insurance industry focused on fixed life insurance products and fixed annuities. Products like term life and whole life are typical fixed products.

Over the past two decades, life insurance companies have focused on diversifying their revenue base by developing and selling retirement planning and asset management focused products. The inherent long-term nature of retirement planning and funding is a natural match for the industry.

The increase in stock market prices during the 1990's led to a significant shift in product sales from fixed life insurance and fixed annuities to variable life insurance and variable annuities. This shift has a material financial impact for the insurer. (Instability in the stock market that began during 2000 has resulted in a significant slowdown in sales of variable products and a renewed demand for fixed products.)

The insurer retains investment and interest rate risk for fixed products. Most variable products shift the substantial portion of investment and interest rate risk to the policyholder. Most variable products include rate guarantees set at very low levels.

In many ways, transferring risk benefits the company. However, during periods of high investment returns, the company's investment returns are less than for fixed products, where excess earnings are retained by the company.

Variable products also generate income differently than fixed products. Fixed products generate revenue through both insurance premiums and the portion of investment return that is above the fixed rate credited to the product. Variable products generate revenue through fees for insurance coverage and asset management fees for the portfolio of investments underlying the product. The shift to variable products can create a more stable revenue flow based on fee income rather than investment returns.

Typical Balance Sheet

The shift to variable products from fixed products has ramifications for financial statement presentation.

The largest asset category on the balance sheet for the typical life insurance company is cash and investments. Funds collected by insurers through the sales of fixed products fund the investment portfolio.

The majority of the general investment portfolio (about 70 percent) is invested in high quality bonds. About ten percent of the portfolio is typically invested in mortgage loans. The balance is split among common stock, real estate, cash and policy loans. States have strict investment laws limiting the percentages, and risk exposures of company investments.

Deferred policy acquisition costs consist of the expenses necessary to sell and issue a policy such as agent commissions and underwriters' salaries and benefits. These expenses are paid early in the policy term. Under the GAAP matching concept items are expensed in the same period the corresponding revenue is earned. Since these costs are paid early in the policy term a prepaid asset is recorded. The asset is expensed over the expected length of time the policy will be in force. Most types of life insurance policies remain in force for many years. Therefore, the prepaid expense (asset) is amortized over the actuarially estimated life, which may be many years. As a result DPAC

is often a material item on the balance sheet of life insurance companies.

Variable products, indexed products and some modified guaranteed products are accounted for through the use of 'separate accounts'. Separate accounts are separate line items in both the assets and liabilities sections of the balance sheet. The amounts should be comparable.

Separate accounts represent segregated portfolios of assets owned by a life insurance company. The accounts are segregated because investment experience is credited directly to the participating policies covered.

The corresponding liability recorded on the balance sheet represents the ownership interest in these funds by policyholders and beneficiaries.

Separate accounts are segregated from the balance of the investment portfolio because the assets and related investment gains and losses are insulated from the company's creditors and liquidation claims.

Due to customer interest in various sectors of the stock market, separate account investments are diverse. They are often of a higher level of risk than those in the general investment portfolio. State law allows separate account assets to be invested without the strict limitations imposed on the general investment account. Customers choose the types of investments that will be held based on their risk appetite. Separate account offerings can look similar to those of mutual funds. For example, separate accounts investments may be focused towards common stock or bonds, 'high-tech', small cap, international, growth or income focused investments.

Typically, cash, invested assets, separate accounts and deferred policy acquisition costs will account for the majority of total assets. The remaining amounts are spread among a variety of accounts depending on the types of business in which the company is involved.

The majority of liabilities are spread among a variety of accounts that represent reserves for current or expected future claims. These reserves are actuarially determined based upon estimates of mortality, morbidity and longevity. Reserves for life insurance policies begin to be accumulated once the policy is sold, and increase each year. As mentioned previously, separate accounts have both an asset and a corresponding liability.

A life insurance company's counterpart to retained earnings is called surplus. At the time of publication the industry is strongly capitalized with surplus supporting about seven percent of total assets.

Risk-Based Capital (RBC) Requirements

As noted in Section 930, state insurance regulators measure an insurance company's capital by its risk-based capital ratio. The ratio is total adjusted capital divided by authorized control level risk-based capital.

The life and health insurance risk-based capital formula considers the four major risk categories of:

- Asset risk – the risk that an insurer's assets will default or decline in value.
- Insurance risk – the risk related to improper underwriting assumptions
- Interest rate risk – the risk of changing interest rates on assets and liabilities
- Business risk – other risks not included in the other three categories.

Risk-based capital results for life and health insurers are evaluated at various levels:

- 250% and above – adequate, no further action required.
- 200-249% – trend test level, a trend test is conducted to determine if an adverse trend exists. An adverse result requires the insurer to file an RBC corrective plan with the state. A favorable trend result requires no further action.

- 150-199% – Company action level, a corrective plan is required.
- 100-149% – Regulatory action level, appropriate examination procedures are required with corrective actions implemented.
- 70-99% – Authorized control level, a commissioner may take action against the company.
- Below 70% – Mandatory control level, the commissioner must seize the company unless there is a reasonable expectation that the condition will be resolved within 90 days.

Typical Income Statement

Under statutory accounting a life insurance company income statement is called a summary of operations. Given the more conservative nature of statutory accounting revenue tends to be recognized at the later of earned or received and expenses at the earlier of accrued or paid.

The statements shows various expensed amounts related to policy reserves. These are amounts recorded at actuarially determined periods throughout the life of the policy, not at the time of policy payment.

The life insurance industry does not have a counterpart to the combined ratio. However, for traditional fixed life insurance products and fixed annuities, the concept is similar although the time period may be even longer.

For fixed return products, the life insurance company receives the premium and invests the funds until policy benefits are paid to beneficiaries many years later. The company's success is measured by its ability to generate higher investment returns than the return guaranteed under the product.

The model is different for variable return life insurance and annuity products. Insurance companies charge a fee for the life insurance coverage provided by the product and in addition, charge a fee for the management of the underlying investment portfolio. This management fee makes up for the loss of the excess investment return earned on fixed products.

PROPERTY/CASUALTY INSURANCE

Property/casualty insurance companies are in the business of accepting the transfer of risk of financial loss from policyholders. Customers transfer the risk of loss, or decrease in value of automobiles, homes and other property as well as the risk of financial loss due to damages done to others (casualty losses).

A major factor impacting property/casualty companies is their exposure to catastrophe losses. Catastrophes are a single event that results in insured losses (to the industry) of $25 million or more. Most are weather related but they can result from other manmade events as well.

Although catastrophes are normal, expected events, they cannot be eliminated, controlled or accurately predicted with any large degree of reliability. For example, no one knows how many hurricanes, of what intensity and geographic course will occur in a season.

The exposure to catastrophe losses has significant repercussions in the way companies select, underwrite and price policies. It also impacts the degree of reinsurance needed to manage the business and the investment goals in managing the portfolio.

Catastrophes are easily understood to impact property insurance. Damage to homes, cars and commercial buildings by major weather events are often seen on the evening news. However, catastrophes also impact casualty insurance. For example, a hurricane that reaches an area during business hours may result in injuries to employees covered by workers' compensation insurance, customers of businesses covered by general liability insurance, and the general public injured by flying property and debris also covered by various types of liability insurance (both personal and business insurance).

Another major factor affecting property/casualty insurance is the short-tail or long-tail nature of the various types of insurance business. Short-tail lines of business are those where claims are paid within a short period of time after the loss occurs. Minor auto accidents that do not result in injuries are an example of this. Property insurance coverage is typically short-tail business.

Long-tail lines of business are those that take many years to resolve. Many casualty lines of business are long-tail lines of business. Medical malpractice insurance for pediatricians is a long-tail line of insurance. Laws allow claims to be brought by parents. However, the laws also allow the child to bring their own actions upon becoming an adult. The time between notice of a potential claim and final resolution may span decades in this type of insurance.

The potential time spans in resolving claims has serious ramifications in the company's investment strategy both in terms of risk and durations.

One of the ways in which property/casualty insurance differs from life insurance is in the duration of the policy.

Most property/casualty policies are written for a term of one year. Some companies still issue personal automobile insurance policies for 6 months. Life insurance policies are expected to span many years. This difference in term impacts financial statements.

Just as with life insurance companies, property/casualty companies are in the business of collecting premiums and fees, investing the funds and paying claims to policyholders and claimants.

For a claim to be covered by the policy it must occur during the policy period, regardless of when the insurance company is notified. The loss to the policyholder must also be from a cause of loss covered by the policy. It must also not have occurred as a result of an act of the policyholder intending to cause a loss.

Although a policy may be in force for 12 months, losses that occurred during the policy may be paid out over many years. For example, a person injured in an automobile accident may require medical treatment for many years. If a covered loss occurred during the policy term, expenses will be paid, many years later, up to the policy limit, even though the policy has long expired.

Typical Balance Sheet

As with life insurance companies, the largest asset category for property/casualty insurance companies is cash and investments. However, because property/casualty companies do not have separate accounts business a larger portion of total assets is in this category. Typically this category accounts for about 88 percent of total assets. Bonds are the largest portions of the portfolio. Typically bonds are about 65 percent of the total portfolio. Bonds are valued at amortized cost.

Common stock is the second largest component of the portfolio accounting for approximately about one quarter of the typical insurers investment portfolio.

The remaining 12 percent of total assets are spread among a variety of accounts including amounts due from agents for payment of policies and amounts due from reinsurers.

Property/casualty companies have built substantial amounts of retained earnings over the years. Property/casualty companies call retained earnings, capital stock and other amounts policyholders' surplus. Low catastrophe losses during the last half of the 1990's, strong investment results and judicious use of reinsurance have increased the level of surplus by the end of the decade. Recent events may result in decreased surplus for certain affected companies. The industry is expected to remain well capitalized.

The largest portion of liabilities is in accounts related to claim reserves. These accounts include reserves for the payment of claims as well as those for payment of expenses incurred in investigating and administering claims. Claim related reserves have decreased as a percent of assets over recent years not due to changes in loss patterns but due to strengthened surplus.

Risk-Based Capital Requirements

As noted in Section 930, state insurance regulators measure an insurance company's capital by its risk-based capital ratio. The ratio is total adjusted capital divided by authorized control level risk-based capital.

The property/casualty risk-based capital formula considers the four major risk categories of:

- Investment risk – the risk that an insurer's assets will default or decline in value.
- Credit risk – the risk of default by agents, reinsurers and other types of creditors.
- Underwriting risk – considers the risk of adverse reserve development as well as the risk of inadequate rates.
- Off-balance sheet risk – the risks of excessive growth and contingent liabilities.

Risk-based capital results for property/casualty companies are evaluated based upon:

- 200% and above – Adequate level, no further action.
- 150-199% – Company action level, a corrective action plan is required.
- 100-149% – Regulatory action level, appropriate examination procedures and corrective action plan are required.
- 70-99% – Authorized control level, a commissioner may take action against the company.
- Below 70% – Mandatory control level, the commissioner must seize the company unless there is a reasonable expectation that the condition will be resolved within 90 days.

Typical Income Statement

A property/casualty company's financial success at underwriting insurance policies is measured through the combined ratio. This ratio measures the proportion of earned premium remaining after claim costs are incurred and the proportion of written premium remaining after the expenses of selling and issuing the policy. The industry typically has a combined ratio result slightly above 100. A combined ratio of 100 means that claims and expenses equal premium. In other words, underwriting results are at breakeven.

TITLE INSURANCE

Title insurance guarantees a clear title to real property. The policy is issued at the time of transfer or sale. Title insurance is a product that seeks to eliminate the risk of loss before the transaction by identifying any liens or judgments that would prohibit the transfer of a clear title. This differs from other types of insurance that reimburse for incurring a loss.

Title insurers, by researching the property history, identify potential problems thereby allowing a property purchaser to change the purchase decision or resolve the problem prior to purchase. It that way they seek to prevent claims from occurring. This differs from other types of insurance. For instance, a typical homeowners insurance policy does not prevent a fire from occurring, rather it reduces the potential financial impact to the homeowner should a fire occur.

Title insurance companies have a different business model than other types of insurance. Most insurers collect premium and incur the majority of their expenses (claims and claim adjustment) after the policy is effective. Title insurers historically have extremely low loss ratios (typically well below 20 percent) but incur the bulk of expenses prior to the effective date of the policy. Title insurers are in the business of risk elimination, not loss payment.

The effective date of the policy is typically the date of purchase. Prior to that time the title insurer engages in extensive and detailed investigation of the ownership history, filed liens and encumbrances on the property. The intent is to assure passage of a clear title. The difference in the business model results in some differences

in the types of items shown on the company's financial statements.

Typical Balance Sheet

The balance sheet reflects an asset "Title plants and other indexes" which reflects the accumulated value of all the properties researched over the years. The title plant is an asset whose value is based upon the ability to reuse that information and update it the next time the property is sold or transferred.

A title insurer will typically show the title plant as the third largest asset behind cash and investments. This long-term asset is not depreciated because the knowledge is not expected to decline in value over time.

Title insurance companies are not subject to risk-based capital requirements. Instead, each state requires that a minimum dollar amount of capital be held.

Typical Income Statement

Because title insurers focus on preventing claims, expenses related to payments under the policy terms are not the largest expense. Rather, administrative expenses to research titles, maintain the title plant and issue title policies account for the majority of expenses.

Claims do occur however, in spite of best efforts to prevent them. About 20 percent of premiums earned are eventually paid out in claims.

Title insurer profits can be more erratic than for other types of insurance. Title insurance is directly tied to the strength of the housing market. Increasing mortgage rates or recessions can slow home sales resulting in fewer title insurance policies being sold. Decreasing mortgages rates or economic recoveries can increase home sales and refinancing resulting in significant increases in title policies sold.

PRIVATE MORTGAGE INSURANCE

Lenders require private mortgage insurance (PMI) when the mortgage loan is for more than 80 percent of the appraised value of the home. The borrower pays for PMI but the lender is the policy beneficiary. Most borrowers obtain PMI coverage from the company offered by the lender although they have the option of obtaining it elsewhere.

Traditionally, the institution received a fee for each PMI client successfully referred to the PMI carrier. Over the last several years, thrift holding companies have established reinsurance subsidiaries to underwrite PMI reinsurance. The subsidiary typically provides PMI reinsurance only for a PMI carrier offered by the lender and for loans it originates.

Institutions and their holding companies have expanded their involvement into reinsurance for several reasons. Reinsurance premiums increase revenue. Lending also becomes more effective as the revenue generated from each loan increases. PMI also diversifies the sources of revenue generated within the structure by generating fee income rather than interest.

PMI companies have marketed this approach to institutions for several reasons. The participation of the institution in the risk of default is thought to strengthen the institutions risk selection process. The institution also shares in the risk of loss by providing reinsurer to the carrier.

PMI reinsurance is typically structured in one of two ways. The reinsurer may provide participating coverage of a certain percentage of each claim. A participating program results in the institution being financially responsible for a predetermined percentage of each claim.

More commonly, the reinsurer provides a set portion of excess coverage. Excess coverage is described in terms of 'layers' that stack on top of each other. Under excess coverage, the PMI carrier accepts the initial layer up to a predetermined dollar amount or percentage of covered loans. After that limit has been reached, the next layer of

coverage is activated. Claims in this layer are those usually covered by the reinsurer. Typically, the reinsured layer has both a floor and ceiling. The floor is the initial amount that must be paid by the PMI carrier before the reinsurance assumes any claims. The ceiling is the maximum amount covered by the reinsurance. Typically, after the ceiling has been met, the PMI carrier pays any additional claims.

Although the possibility of claims must exist for the program to be considered reinsurance, the expectation is for claims to rarely reach the layer of reinsurance coverage.

The PMI industry estimates claims rates at two percent to six percent of covered loan amounts. Actual results depend on economic factors and lending criteria. Reinsurance agreements are typically structured to begin at a percentage of loss greater than what would normally be expected from underlying loans.

INSURANCE AGENCIES AND BROKERS

Either agents or brokers can sell insurance. Agents work on behalf of the insurance companies they represent. They may be employees of the insurance company or they may be independent business people who choose to represent the insurance company.

Independent agents work on behalf of insurance companies but are independent businesses. They typically represent many different companies. Their competitive advantage is their ability to offer customers an array of products from various companies to meet their insurance needs. The insurance companies that they represent pay them commissions. Most companies also supplement agent compensation with bonuses based on growth and profitability.

Captive agents work on behalf of a single insurance company but are independent businesses. To the public they may appear to be employees of the insurance company. Their competitive advantage typically rests in the strong brand name and market presence of the insurance company they represent. Insurance companies that market through captive agents typically support the agents through strong training programs, advertising support and administrative programs. Captive agents are paid commissions often supplemented by growth and profitability bonuses.

Agents who are employees work for a single insurance company. They may work in a locations separate from the company offices. They are often paid a small base salary supplemented by commissions. Office administration, advertising, marketing, sales volumes and types are usually strictly controlled by the company.

Brokers represent customers rather than insurance companies. Their role is to bring together the buyer with appropriate insurance companies, analyze coverage needs and make recommendations. They are independent businesses. They are paid through commission. Some insurance companies do not pay growth and profitability bonuses to brokers, others do.

Agents and brokers must be licensed by each state in which they sell insurance. Most states require continuing education in order to renew licenses.

Historically, licensing requirements varied widely from state to state. Gramm-Leach-Bliley proposed the creation of the National Association of Registered Agents and Brokers (NARAB). Under this law NARAB would come into effect to create uniformity in agent and broker licensing unless a majority of the states enacted conforming legislation by November 12, 2002. A majority of states have passed laws that provide for reciprocity, a first step towards consistency.

Agents and brokers do not use SAP. Agents and brokers that are privately held may create cash basis or tax basis financial statements.

Agents and brokers are not required to file financial statements with the department of insurance. The department has the authority to request them at any time.

Sales of insurance products by thrifts, or on behalf of thrifts to consumers are regulated by 12

CFR Chapter V Part 536 Consumer Protection of Sales of Insurance. The rule became effective October 1, 2001. It implements requirements of Gramm-Leach-Bliley.

REINSURANCE

Reinsurance is insurance for insurance companies. Property/casualty companies use reinsurance more extensively than life insurance companies. An insurance company that sells its products to the public may also be a reinsurer for other insurance companies. There are also companies that only sell reinsurance.

Reinsurers are regulated less rigorously than insurance companies that deal with the public. Both parties in a reinsurance transaction are assumed to be knowledgeable in insurance and are therefore better prepared to protect their interests.

Reinsurance can be issued either for one policy (facultative) or for a group of many similar policies (treaty). Facultative reinsurance is used for large, complex, individualized policies. For instance, a large casino, horse racetrack and hotel complex with one owner would be more appropriately handled through facultative reinsurance.

Treaty reinsurance is typically used for types of business where many similar policies are issued. For instance, treaty reinsurance is very common for private passenger automobile insurance, homeowners insurance and small business insurance.

Insurance companies use reinsurance for several reasons. Property/casualty companies can use reinsurance to spread risk related to geographic concentrations. Companies with heavy concentrations of policyholders in locations exposed to weather catastrophes may choose to reinsure a potion of the business to reduce the risk of loss.

The purchase of reinsurance results in the receipt of a commission for producing the business. Reinsurance commissions flow into revenue thereby reimbursing a portion of the expenses incurred to generate sales. As discussed previously, under SAP, policy acquisition costs are immediately expensed. Reinsurance commissions offset a portion of these expenses.

Reinsurance can also be used to stabilize underwriting results by moving a portion of the risk to another insurer. Companies often reinsure particularly high-risk accounts, whether large, complex property/casualty accounts or large life insurance policies. Reinsuring the risk reduces the amount of the claim that will be incurred when an insured event occurs.

Companies also can obtain reinsurance when they would like to exit a line of business. A substantial reinsurance program can minimize the exposure of the company to the results of that business segment.

SUMMARY

Although part of the financial services industry, insurance operates differently than thrifts in many ways. A basic understanding of the industry can help you to identify potential problem areas and more effectively plan examination steps for insurance holding companies.