

2019 DIVIDEND INTEREST RATES AND HISTORICAL PERSPECTIVES

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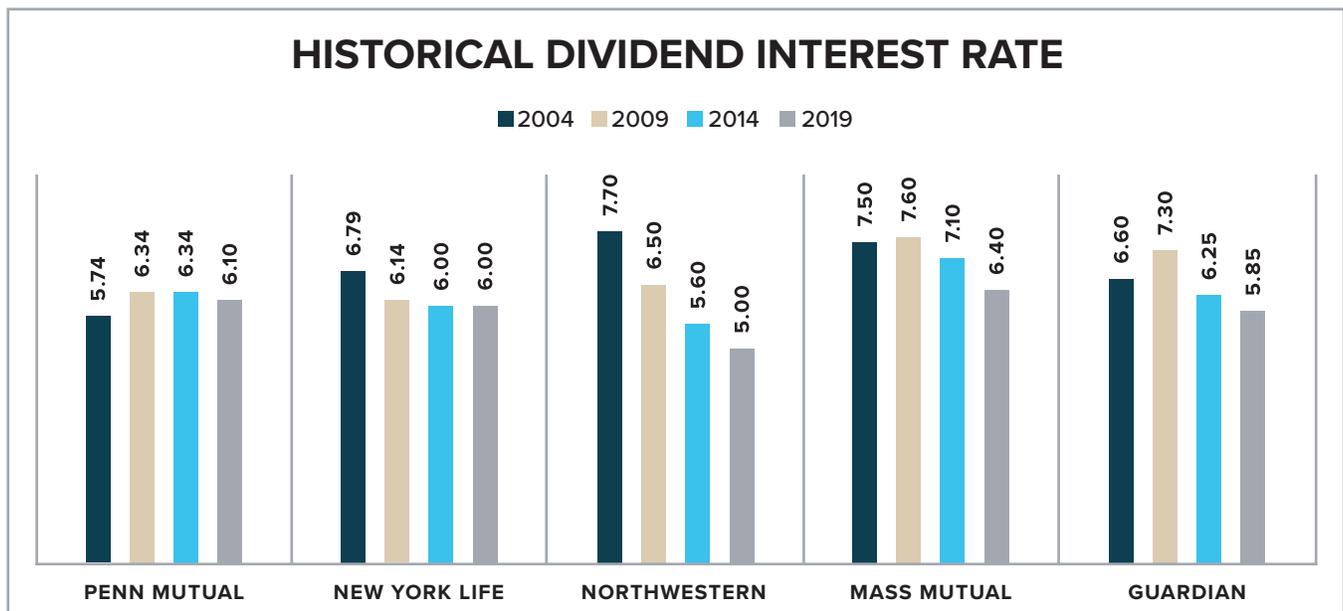
Several of the mutual life insurance carriers recently declared their 2019 dividend scale on participating whole life policies. While life insurance dividend calculations reflect mortality experience, expenses, and interest rates, the most commonly reported component is the dividend interest rate (DIR). As shown in Figure 1, the 2019 DIRs were largely held close to 2018 DIRs except for Penn Mutual.¹

Figure 1—Dividend Interest Rate Comparison

Dividend Interest Rates (%)	2019	2018	Change
Guardian	5.85	5.85	0.00
Mass Mutual	6.40	6.40	0.00
Northwestern	5.00	4.90	0.10
New York Life	6.00	6.10	-0.10
Penn Mutual	6.10	6.34	-0.24

A quick look at historical DIRs (Figure 2)ⁱⁱ shows a general trend of decline as you might expect from a product backed primarily by bonds.

Figure 2—Historical Dividend Interest Rate

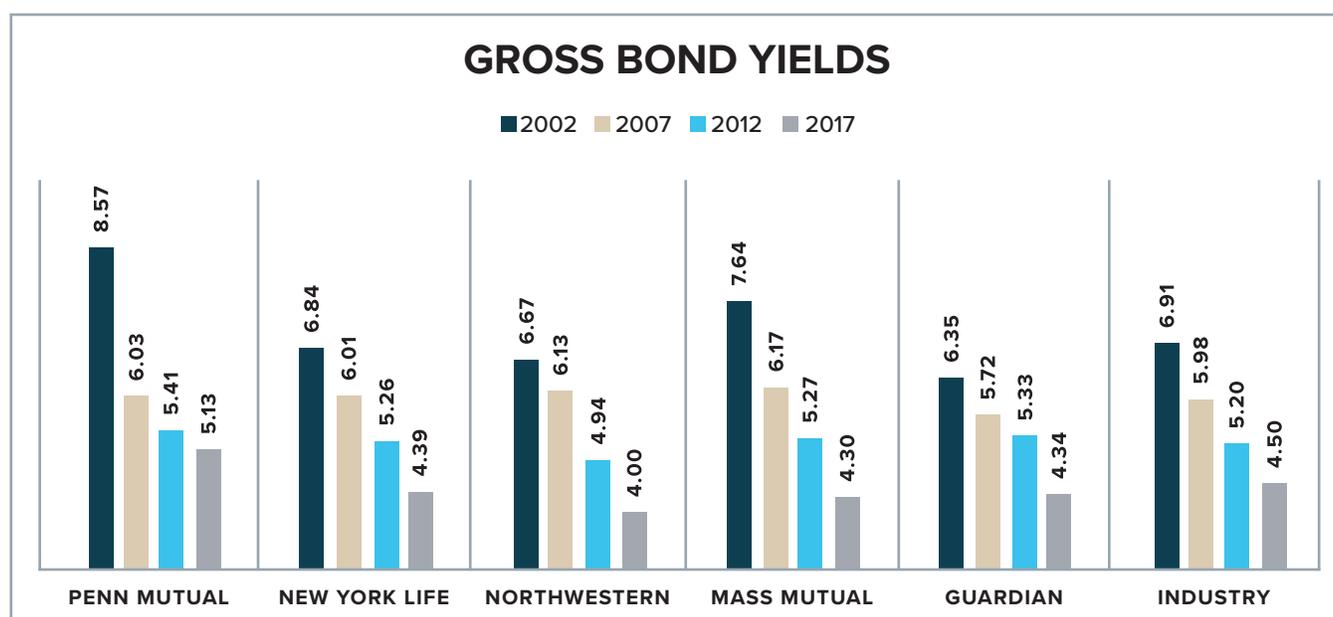


Bonds are the economic engine driving the life insurance industry (Figure 3ⁱⁱⁱ). Bonds typically comprise 75% of the life industry’s investment portfolio. There’s simply no escaping the relationship between bond yields and the yields that carriers may pass along to bond backed products such as whole life, universal life, and fixed annuities. The press of sustained low interest rates is evident in Figure 4. Gross bond yields^{iv} have declined by over 1/3 industry wide. The spread between what a carrier earns on investments and what it credits to policies is a key source of profitability and revenue for carriers. However, life insurance products typically have guaranteed earnings rates (generally 1-2% in new products today vs. 4-6% in older products). The result is that carriers experience spread compression as investment portfolio yields decline closer to or below the guaranteed minimum returns carriers must pay on products. This compression has been a major challenge for carriers during the current long period of low interest rates.

Figure 3–Investment Portfolio Composition End Of Year 2017

Asset Category	Industry	Guardian	Mass Mutual	Northwestern	New York Life	Penn Mutual
Bonds	75.51	78.42	60.27	67.67	71.70	83.16
Preferred Stock	0.26	0.00	0.55	0.12	0.05	1.01
Common Stock	0.95	1.10	1.18	2.49	1.08	0.58
Mortgages	12.18	8.23	16.31	16.39	11.77	0.00
Real Estate	0.61	0.71	0.62	1.08	1.14	0.31
Contract Loans	3.31	7.24	9.63	8.02	8.17	2.99
Cash & Short Term	2.56	1.14	2.59	1.14	1.82	2.70
Other (Sched. BA)	4.62	3.15	8.85	3.08	4.26	9.25

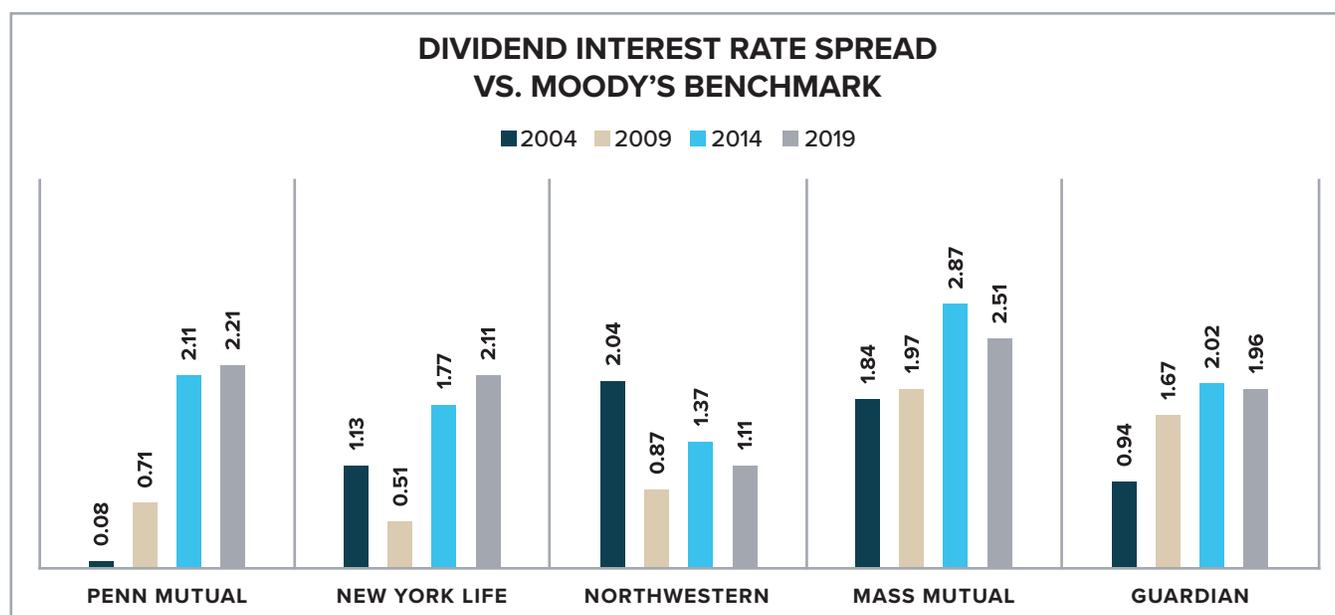
Figure 4–Gross Bond Yields^v



Caution for the Future?

An element which may not be readily apparent is a general trend of DIRs increasingly deviating more from historical benchmarks such as the Annual Average of Monthly Moody's Seasoned 10 Year Aaa Corporate Bond Yield ("Moody's Benchmark"). Figure 5 shows the historical gap by which DIRs have outpaced the Moody's Benchmark in 2019, 2014, 2009, and 2004. For example, Guardian's DIR in 2004 was just shy of one percentage point higher than the Moody's Benchmark, but for 2019 the gap is double the 2004 gap. One notable exception running counter to the trends of the other carriers is Northwestern Mutual. This is logical as Northwestern has reduced the DIR more than other carriers in recent years. Still according to their own publications^{vi}, even Northwestern Mutual is crediting a rate considerably higher than their portfolio yield. Clearly, something is not adding up.

Figure 5^{vii}—Dividend Interest Rate Spread vs. Moody's Benchmark



How long can carriers support a DIR in excess of portfolio yields that is well above historical levels? Using Northwestern as an example, the reduction in spread was accompanied by a reduction in their DIR. If the other carriers seek to return to a spread closer to lower levels of the past, will we see a similar reduction of DIR? Is a very high spread perhaps a leading indicator of a higher risk of a DIR reduction in the future? Only time will tell the answer to those questions.

Policyholder Dividends and Carrier Capital & Surplus

At the most basic level for a carrier, assets = liabilities + surplus. Merriam-Webster defines "divisible surplus" as "the part of the annual surplus fund of an insurance company which is available for payment in the form of dividends to policyholders." So higher levels of Capital & Surplus should be an indicator of the capacity of a carrier to make dividend payments to policyholders. It's easy to see large increases in Capital and Surplus^{viii} from 2002 through 2017 in Figure 6. However, the surplus increase hasn't translated to the same pace of increase in Policyholder Dividends (Figure 7^{ix}).

Figure 6—Capital and Surplus (in \$000s)

Carrier	2017	2012	2007	2002
Guardian	6,683,677	4,752,013	3,750,545	1,913,262
Mass Mutual	15,705,217	12,686,884	8,008,148	6,104,603
Northwestern	20,850,229	16,175,773	12,105,970	7,217,143
New York Life	20,356,950	16,568,538	11,959,230	7,985,451
Penn Mutual	1,697,400	1,495,391	1,302,211	806,099

Figure 7—Policyholder Dividends (in \$000s)

Carrier	2017	2012	2007	2002
Guardian	903,252	791,666	651,401	513,980
Mass Mutual	1,569,131	1,378,516	1,372,522	1,163,238
Northwestern	5,337,642	5,038,105	5,008,470	3,791,948
New York Life	1,958,311	1,402,673	1,644,148	1,292,449
Penn Mutual	96,924	31,742	32,475	48,631

An interesting perspective is gained when the Policyholder Dividends are measured as a percentage of Capital & Surplus. Let's call this the Dividend Payout Ratio. As shown in Figure 8^x, carriers appear to have dramatically reduced the amount of surplus being paid out to policyholders as dividends. Figure 9^{xi} shows 40-50% declines from 2002-2017 in this measurement for all carriers except Penn Mutual. Had we measured the prior year, Penn Mutual would have displayed a similarly large decline like the other carriers. Although the dollar amounts of the dividends paid in total to policyholders have increased over time, it would seem significantly less of the Surplus is returned to policyholders on a percentage basis. It's also interesting to see the stark differences in the amount of surplus paid out across carriers. Penn Mutual is often touted for maintaining the same dividend scale for a recent 10-year period. This data would suggest that statement is less impressive when you realize how little of the surplus is returned by Penn Mutual to policyholders.

Figure 8—Dividend Payout Ratio

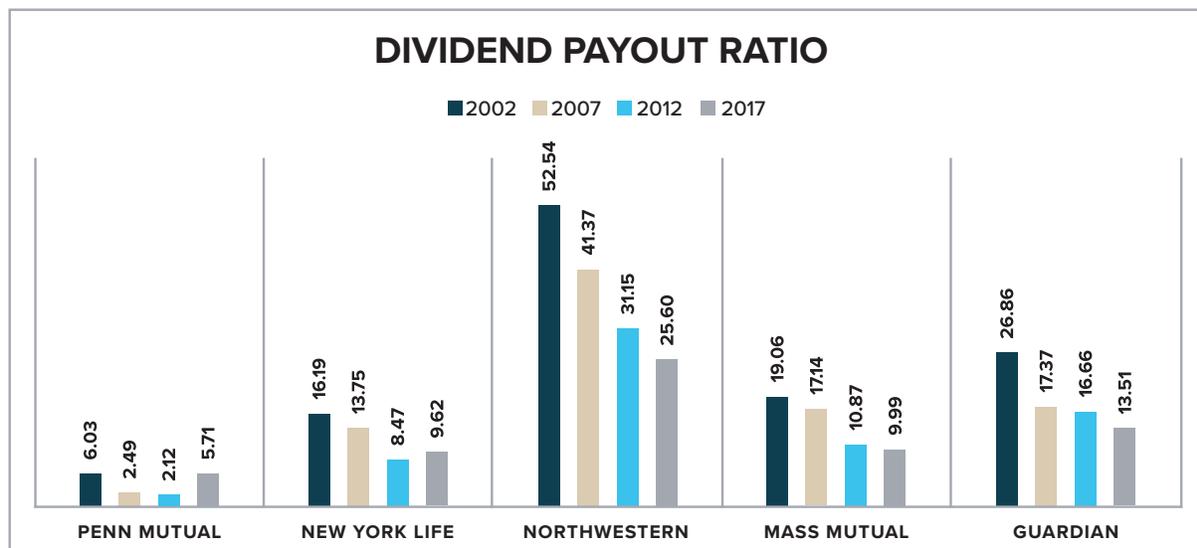
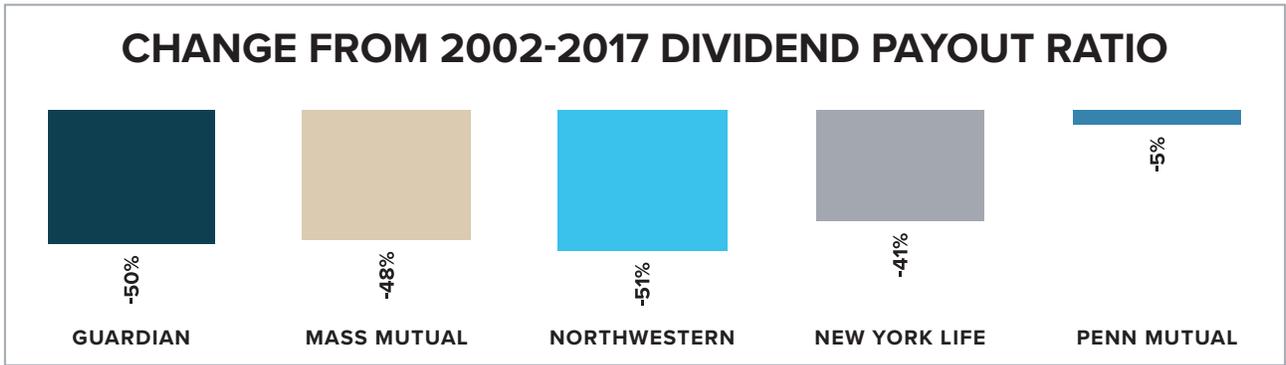


Figure 9—Change From 2002-2017 Dividend Payout Ratio



Now, turn an eye towards the capacity of the carrier to pay a dividend. For this measurement, surplus is compared to liabilities since surplus is a cushion against the liabilities being understated (i.e. bad experience or adverse economic conditions). Some portion of this surplus is paid as dividends while typically a much larger proportion is held as a buffer against the uncertainty of the liabilities. However, the Dividend Capacity Ratio tells us how much the carrier could technically pay out in dividends.

Figure 10^{xii}—Dividend Capacity Ratio

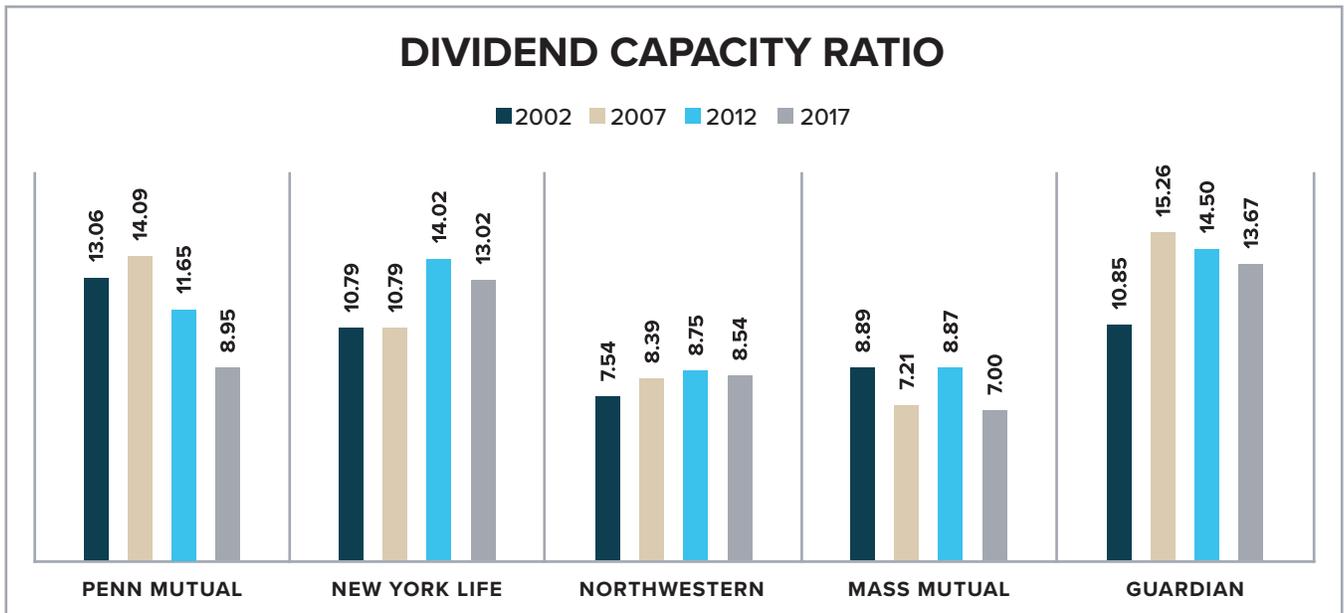
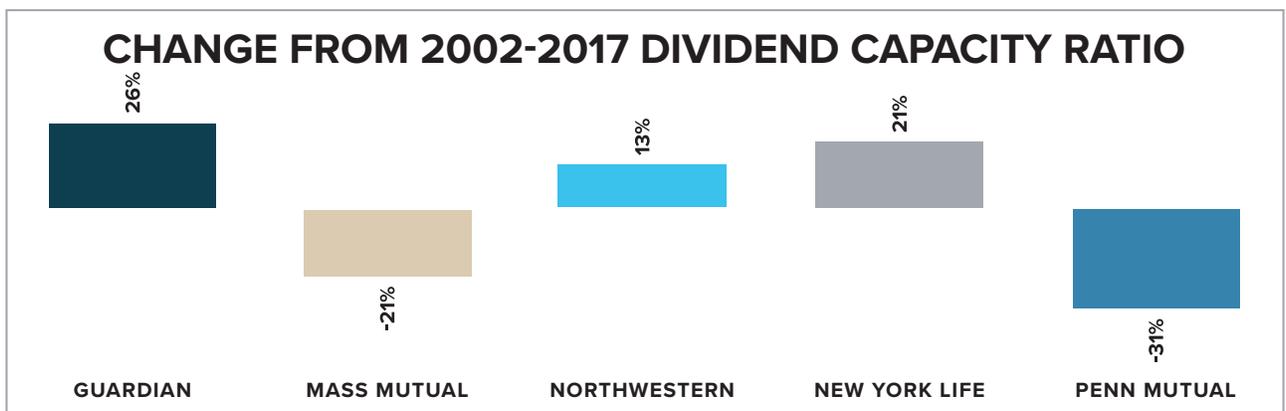
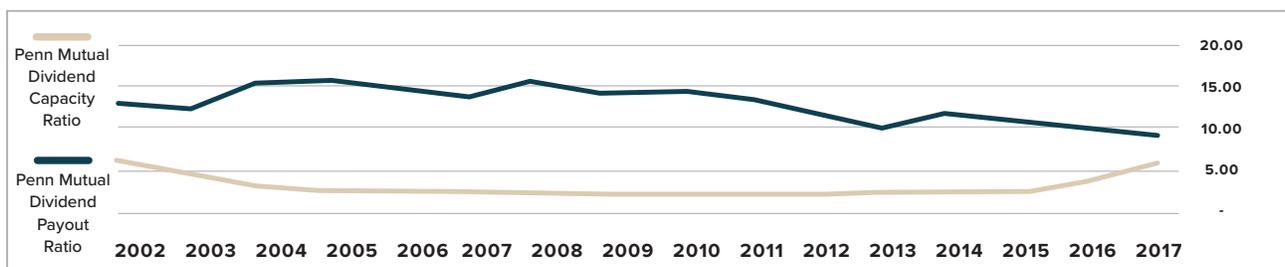
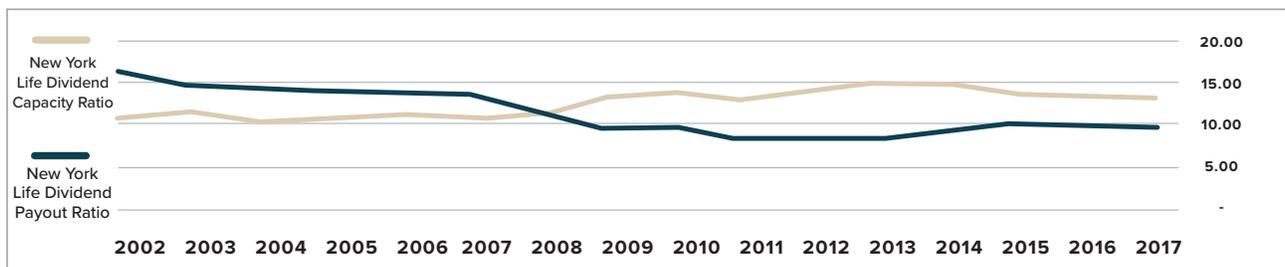
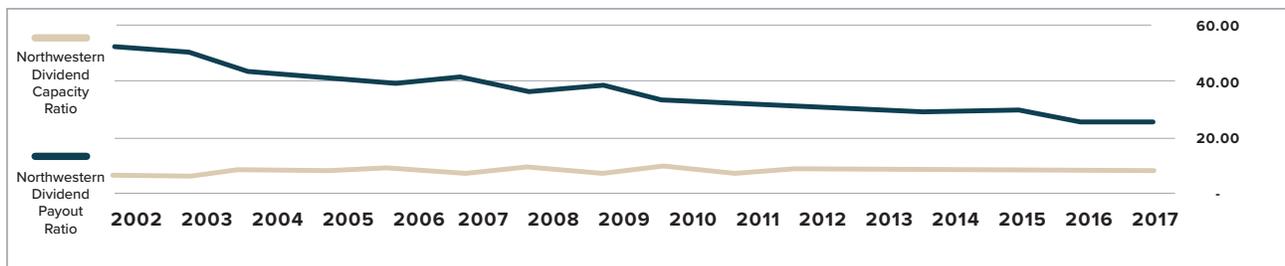
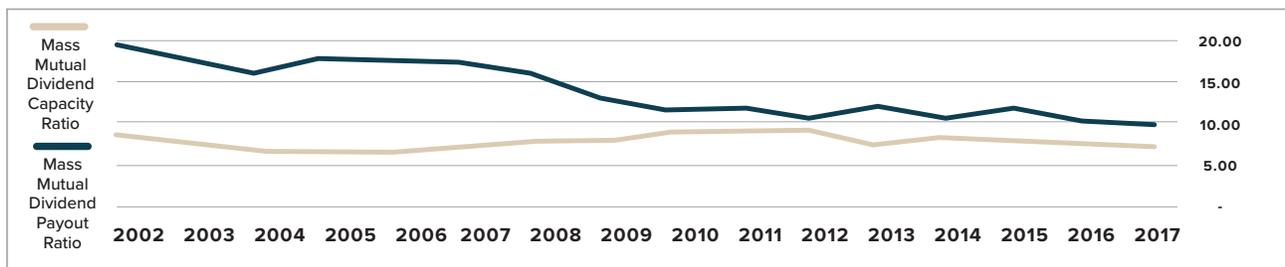
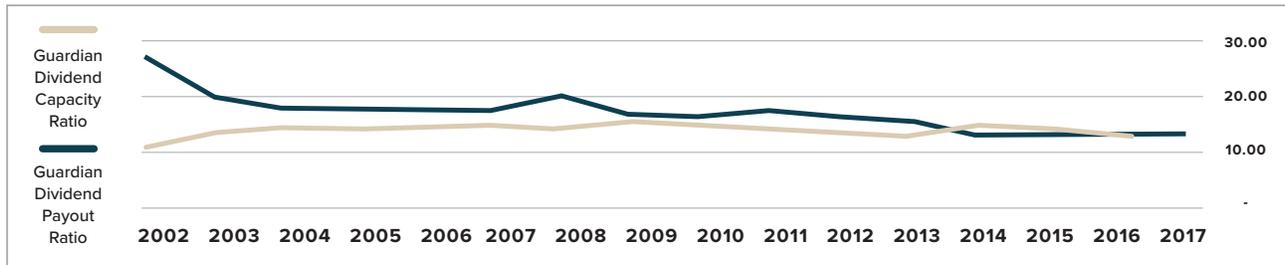


Figure 11^{xiii}—Change From 2002-2017 Dividend Capacity Ratio



This data implies that New York Life and Guardian may have a higher capacity to pay dividends. It also implies the dividend capacity of Penn Mutual and Mass Mutual has declined significantly. Figure 12 simply shows the Dividend Capacity Ratio and the Dividend Payout Ratio over time. This seems to imply Mass Mutual is being more aggressive by holding a lower capacity than the other carriers. Northwestern seems disciplined in maintaining a relatively steady capacity albeit at the expense of dividends paid. Said another way, Northwestern seems willing to sacrifice dividends to maintain a desired financial strength position. New York Life appears well positioned from a dividend capacity perspective with a capacity ratio over 50% higher than Northwestern and 86% higher than Mass Mutual. Time will tell if this capacity sits idle or is distributed to policyholders as dividends.

Figure 12^{xiv}—Dividend Capacity Ratio and Dividend Payout Ratio



The Influence of Bond Maturity

An analysis of bond maturity durations hints at which carriers may be suffering currently but be better poised for a rise in interest rates and which carriers may have guessed correctly on the path of interest rates in recent years. Figure 13^{xv} shows the bond maturity distributions for the life industry as well as the mutual carriers in 2017 and 2007. Figure 14^{xvi} shows the percentage change in the maturity distribution for the carrier. It's important to use Figures 13 and 14 together. For example, Mass Mutual had a 285% increase in maturities over 20 years, but that change brought it more in line with the industry average distribution (17.98 vs 20.78). Penn Mutual had significant increases in both 10-20 year and > 20-year maturities. The result is Penn is 26% higher in 10-20-year maturities than the industry average and 47% higher in maturities > 20 years. It's also worth noting that Penn has much less allocated to maturities under 5 years. Clearly Penn made a conscious decision to go long in bonds. The higher yields in the longer durations likely has helped Penn maintain their DIR at a steady rate for the 10-year period prior to the announced 2019 reduction. Conversely, Northwestern shifted to a shorter-term distribution compared to 2007...seemingly betting that interest rates would rise. This is probably a factor in Northwestern having larger reductions in their dividend interest rates compared to other carriers.

Figure 13–Bond Maturity Distribution %

	< 5 Years		5-10 Years		10-20 Years		> 20 Years	
	2017	2007	2017	2007	2017	2007	2017	2007
Industry	31.48	36.95	29.84	30.79	17.77	13.87	20.78	18.39
Guardian	25.23	15.28	33.05	46.75	11.64	12.27	30.08	25.71
Mass Mutual	39.51	47.15	28.37	30.79	14.14	17.40	17.98	4.66
Northwestern	41.30	34.67	33.43	34.65	12.74	18.20	12.53	12.48
New York Life	34.14	37.90	34.78	29.15	21.16	17.39	9.92	15.56
Penn Mutual	21.03	45.06	25.98	31.41	22.50	8.51	30.48	15.01

Figure 14–Change in Bond Maturity Distribution from 2007-2017

Change	< 5 Years	5-10 Years	10-20 Years	> 20 Years
Industry	-15%	-3%	28%	13%
Guardian	65%	-29%	-5%	17%
Mass Mutual	-16%	-8%	-19%	285%
Northwestern	19%	-4%	-30%	0%
New York Life	-10%	19%	22%	-36%
Penn Mutual	-53%	-17%	164%	103%

Northwestern and Penn would seem to be at opposite ends of the spectrum regarding the potential impact of rising interest rates. Northwestern would seem to be better poised to take advantage of rising rates with the faster turnover of a shorter duration portfolio. Penn could be disadvantaged if interest rates rise to the point they devalue the longer duration bonds held by Penn. The longer turnover of the portfolio would likely delay positive impacts from rising interest rates.

Why Dividends Matter

Just as bonds are the economic engine for the life industry, dividends are the economic engine for the way modern whole life policies^{xvii} are structured and sold. Policies regularly leverage the illustrated dividends to reduce or stop future out of pocket payments, to support policies with loans, to grow the death benefit, or to reduce the expected premium (in term blends). When actual dividends received on a policy fall below expectations, it can have significant repercussions on a policy as the following two real life examples demonstrate.

Example 1

A 2004 whole life policy with a term blend required a 25% increase in the lifetime annual premium in 2017 from \$31,395 to \$39,447 because of dividend reductions. If the dividend dropped another 1%, the required premium would jump to \$49,523...a 57% increase from the expected premium levels.

Example 2

Two all base whole life policies purchased five years ago were expected to require ten annual premium payments of \$114,060 and \$88,100. Based upon the 2018 dividend scale, the policies now require fifteen annual premium payments resulting in a 50% increase in the out of pocket outlay.

Dividend reductions may also result in policy terminations or face amount declines. The impact on policies will vary greatly as the DIR publicized is typically on un-loaned, all base whole life policies. A policy that doesn't fit into the stated parameters may have a very different dividend applied. Even a policy owner's choice of using a variable loan rate instead of fixed loan rate may impact the dividend formula on some whole life policies. Ongoing policy management^{xviii} is imperative on whole life policies because of the varying reliance upon dividends in policies. It's simply impossible to guess what the impact of dividend fluctuations will be on a policy short of getting up to date inforce illustrations on a regular basis.

Summary

Dividend interest rates are strongly related to bond yields. There is no financial alchemy that lets a life insurance company escape this relationship. As yields have declined on bonds, dividend declines have naturally followed to some degree. To counter falling yields, carriers are modifying investment portfolios including altering bond maturities – whether to position for a rise in interest rates or to protect against continued low rates. At the same time, carriers appear to be paying materially less in dividends when measured as a percentage of Capital & Surplus. Even if interest rates rise in the near future, it will be years before carrier portfolios return to the yields from years ago due to the mixed duration of maturities. This will translate in continued challenges to the dividend formulas across the industry for the foreseeable future.

Although changes in dividends are a natural occurrence as interest rates change over time, the effects on policies can greatly vary based upon numerous factors including term blends, the existence of loans, the type of loan rate, and the type of whole life policy. Because policyholder annual statements are poor indicators of the impact of dividend reductions over time, astute policyholders and their advisors will regularly evaluate the projected impact to their policy with inforce illustrations and make decisions accordingly.

ABOUT THE AUTHOR

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Tom Love is the Vice President of Insurance Analytics for Valmark Financial Group. In his role, he is responsible for advanced life insurance case design, carrier and product analysis, product sales and marketing, development of analytical and educational tools, agent training and agency business development. Mr. Love has over 25 years of experience in the life insurance space spanning a wide range of roles including home office experience, agency experience, and personal production. In addition to earning a Bachelor's degree in Risk Management & Insurance, he currently holds the FINRA Series 6 and 63 securities licenses and life, health and variable licenses.

¹ Source: public carrier announcements and communications to field agencies

² Each carrier calculates its dividend in its own way, which often is not disclosed. The dividend calculation will weigh the DIR, mortality experience, and expenses differently across carriers. As such, the DIRs should not be compared across carriers.

³ S&P Global Market Intelligence

⁴ 2017 is the most current year for which carrier statutory data was available at the time the report was written.

⁵ S&P Global Market Intelligence; Dividend interest rates are compared versus the trailing year Moody's Benchmark rate.

For example, the 2014 DIR is compared versus the 2013 Moody's Benchmark. The 2018 Moody's benchmark is averaged through November as full year data wasn't available at the time of publication.

⁶ The Power of the Portfolio, 29-4692(0502)(REV1117)

⁷ Source: public carrier announcements and communications to field agencies; S&P Global Market Intelligence

⁸ S&P Global Market Intelligence

⁹ Ibid

¹⁰ Ibid

¹¹ Ibid

¹² Ibid

¹³ Ibid

¹⁴ Ibid

¹⁵ Ibid

¹⁶ Ibid

¹⁷ See Chapter 3: Types of Policies in Life Insurance 10X for additional information on whole life policies.

¹⁸ See Chapter 11: Ongoing Policy Management in Life Insurance 10X for additional information on managing policies.