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An Explanation of the Legal Reserve System

The economic challenges that we face in today's world have become second only to the great depression. The recent collapses of banks and large corporations in our country have made people scramble for a place that has security. We are asked often, "Where can we place assets that provide safety and security in uncertain times"? One place that should be considered is life insurance companies that have a Legal Reserve classification.

Life companies that comply with the legal reserve requirements established by the state insurance laws are known as Legal Reserve Life Insurance Companies. Legal Reserve companies had their strongest showing of strength during the Great Depression of 1929-38 when some 9,000 banks suspended operations while 99% of all life insurance in force continued unaffected. Many people are not aware that it was ***not*** the government that bailed out the banking industry during the Great Depression; it was the U.S. insurance companies.

In a financial collapse, the insurance companies would be second only to the U.S. government to fold. This is true because the government has taxing power, and can print money. Reinsurance, acquisitions, and mergers protected virtually all policy owners in the affected companies against personal loss. While thousands of banks closed across the United States, the insurance companies remained in force and continue to this very day. While there is no way of determining the total amount of capitalization of all of these combined legal reserve companies; I would venture to say that no other sector of the economy even comes close.

Some of the companies that we recommend to our clients are hundreds of years old with billions of dollars in assets. Unlike any other enterprise where size is a major measure of financial stability, the legal reserve life insurance company's unique series of safeguards can make even the smallest company a tower of strength. In 1949 Mr. Leroy A. Lincoln, then president of the world's biggest life insurance company, Metropolitan Life of New York, stated: "You're as safe, as well protected and the cost is just as cheap if you buy from a small insurance company as from the largest."

The State Insurance Department
Most state insurance departments mandate a conservative "statutory" accounting system that will insure company solvency. This "statutory" system has been successful for decades in minimizing insurance company failures and preventing policyholder losses. The state insurance department does review and measure the insurance companies' cash flow and liabilities to ensure that they have the cash to meet policyholder obligations. They are audited by state insurance departments at least every 3 years. Life insurance companies also file quarterly and annual statements.

Insurance companies can't capitalize expenses to do business like (World Com) did, and it can't transfer liabilities and declare profits today based on future events like (Enron) did.

The State Insurance Department is a most vital department in each of our fifty states. Acting on its own state's insurance laws and regulations, it supervises all aspects of an insurance company's operation within that state. In addition, the State Insurance Department licenses all companies and agents to sell insurance within its boundaries. It must also approve all policy forms and in some cases, sales materials before they can be offered to the public. The Departments review complaints from consumers and mergers of companies which do business within its boundaries.

Required Reserves Ensure Payment of Policyholder Benefits
A large percentage of each premium dollar calculated by actuaries for each company goes into the policy owner's reserve fund. This policy reserve (Legal Reserve) fund is a liability to the life insurance company. The fund is established as a way of determining or measuring the assets the company must maintain in order to be able to meet its future commitments under the policies it has issued.

If an insurance company's reserve levels fall short, and it goes into what is called receivership, the remaining insurance companies in the state legal reserve pool must assume the liabilities and obligations of the insurer. The amount they are required to accept are based on the amount of insurance and annuities they have issued in that state. If one company has issued 10% of all insurance and annuities in that state, then they must accept 10% of any bankrupt insurer's obligations for that state.

The reserve liabilities are established as financial safeguards to ensure the company will have sufficient assets to pay its claims and other commitments when they fall due. These assets are kept intact for payment of living and death benefits to the insured's. The reserve pool protects annuity investors as well as those who purchase other life insurance products or policies.

Periodic Company Examinations
Every year all legal reserve life insurance companies submit annual statements to the insurance departments of each state in which they are licensed to do business. The format and contents of the forms used are prescribed by the State Insurance Commissioners and they are a detailed report of an insurance company's financial status that is important in evaluating the company's solvency and compliance with the insurance laws. Every few years, depending on a company's home state law, all companies operating in more than one state undergo a detailed home office zone examination of its financial position. This audit is conducted by a team of State Insurance Department Examiners representing the various zones in which the company is licensed to do business. Companies licensed in only one state are subject only to an annual home office examination by their State Insurance Department.

Additional Security Safeguards
1. Reinsurance: Nearly every legal reserve life insurance company further protects its policyholders by reinsuring part of the coverage with a life reinsurance company. This is done when the company will not or cannot undertake a risk alone. Reinsurance prevents relatively sizable claims from depleting a company's policy holder reserves. The amount reinsured depends on many factors such as the size of the individual claim and the number of claims a company can expect.
2. Surplus: The surplus is the amount by which a company's assets exceed its liabilities. The surplus protects the policyholders and third parties against any deficiency in the insurer's provisions for meeting its obligations. The determination of the optimum amount of surplus that a company will retain must be based on experience, current conditions, and an awareness of the primary goal of maintaining a strong company that is always able to pay claims as they arise.