Effects of the McHugh Decision on California's Life Insurance Market

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The *M H,* decision, a landmark ruling in California insurance law, has dramatically reshaped the state's life insurance market. The ruling held that the notice requirements before policy lapses, as mandated by California Insurance Code sections §10113.71 and §10113.72, apply to all life insurance policies in force when these sections became effective, regardless of when the policies were originally issued. As a result, many policy cancellations due to nonpayment of premiums may now be considered incomplete, potentially making insurers liable for death benefits on these lapsed policies. This has triggered a wave of class action lawsuits against life insurance companies.

This paper estimates the potential financial impact of the *M H,* ruling on California's life insurance industry, using publicly available data and actuarial methods. It draws on the 2018 LIMRA/SOA Individual Life Insurance Lapse Survey, the SOA 2015 VBT Mortality Tables, and the National Association of Insurance Commissioners (NAIC) InfoPro database. By analyzing lapse rates, mortality rates, and policy types, the study projects potential liabilities. The findings suggest that California insurers could face up to $22.4 billion in liabilities, underscoring the urgent need for insurers to implement proactive risk management strategies. Insurers must reassess their product offerings, strengthen financial planning, and ensure they are prepared for the potential surge in claims stemming from this ruling.

For policymakers, the *M H,* decision highlights the critical importance of clear and precise legislative language. The California Supreme Court's interpretation of the law has set a new precedent, emphasizing the need for legislators and regulators to communicate new rules effectively to ar

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ABSTRACT

The $M\ H,\ ,$ decision, a landmark ruling in California's insurance law, determined that the notice requirements preceding policy lapse were applicable to all policies in effect at the time, not just those written after the law was enacted. As a result, many policy cancellations for nonpayment of premiums can be deemed incomplete, making life insurers potentially liable for death benefits on these lapsed policies. This decision has reshaped the dynamics of the state's life insurance market. This paper examines the implications of $M\ H,\ ,$ on California's life insurance industry by estimating potential costs and liabilities for life insurers. Our findings reveal significant financial costs, with an estimated liability of up to $22.4 billion for life insurers in California. These insights provide valuable guidance for insurers in risk management, product design, and financial planning, and also inform policymakers on regulatory enhancements and market oversight strategies.

Keywords: Life insurance, $M\ H,\ ,$, lapse

1. Overview

In the realm of financial security, life insurance stands as a cornerstone, offering individuals and families a safety net against unforeseen circumstances. In 2012, the California State Legislature created certain protections to shield consumers from losing life insurance coverage because of a missed premium payment, requiring "each life insurance policy issued or delivered in this state shall contain a provision for a grace period of not less than 60 days from the premium due date..." and "no individual life insurance policy shall lapse or be terminated for nonpayment of premium unless the

2. Background and Prior Literature

The life insurance sector plays a vital role in the economies of all 50 states and the District of Columbia. Investments by life insurers bolster state economies, as individuals and their families attain financial stability through various life insurance products. California boasts the largest life insurance market among all states. In 2022, purchases of life insurance coverage (face amount) in California amounted to $350 billion, with the total life insurance in force reaching $4.6 trillion, and total direct premium receipts at $21 billion (American Council of Life Insurers [ACLI], 2023). In 2022, life insurance coverage (face amount) purchases in the U.S. totaled approximately $3.3 trillion, with the total life insurance in force reaching $38.5 trillion (ACLI, 2023). The U.S. population in 2022 was 333.3 million, with California's population at 39.03 million, according to the United States Census Bureau. This translates to per capita life insurance coverage (face amount) purchases of $9,958 in the U.S. and $8,961 in California, and per capita total life insurance in force of $65,425 in the U.S. and $117,354 in California.

Policy lapses are frequent occurrences in life insurance markets. These policies offer policyholders the option to terminate them before their expiration or payout of a death benefit. A policy lapses when its premium remains unpaid, whether voluntarily or involuntarily, by the end of a specified period (often referred to as the grace period). Following this, the policyholder ceases to make future premium payments, and no death benefit is reimbursed to the policyholder.

During the initial stages of a life insurance policy, premium payments surpass the actuarially fair value of the risk insured. Conversely, in the later stages, premium payments fall below this value. Consequently, policyholders who lapse after maintaining the policy for a sufficient period give up valuefe insur

In *Mc Hugh*, the California Supreme Court determined that recent amendments to the California Insurance Code, which introduced notice requirements preceding policy lapse, were applicable to all policies in effect at the time, rather than solely to new policies issued after the passage of those amendments. *Mc Hugh* paved the way for numerous class action lawsuits against life insurance companies, posing a significant liability threat to the life insurance industry. For those who passed away after years of not paying premiums, claims could be made retroactively (after death) by paying premiums for the losses (deaths) that had occurred.

3. Data and Analysis

3.1. Data and Assumptions

We drew upon publicly available data and employed robust actuarial methodologies to estimate *Mc Hugh*'s potential impact on the life insurance industry in California. We collected lapse rates and exposure by policy year, age, and type of insurance from the 2018 LIMRA/Society of Actuaries (SOA) Individual Life Insurance Lapse Survey. Mortality rates were from the SOA 2015 Valuation Basic Tables (VBT) Mortality Tables.

First, we estimated the amount of premium required to bring lapsed policies current. The formula differs by type of insurance and ignores expense and profit loads.

For annually renewable term (ART) policies, the premium is determined each year between the lapse year and the death year -1 and is the present value of expected death benefits in each year as a percentage of the average policy face value, F. We assumed an interest rate, , equal to 5%

(1)

where k = 0 for the year when a policy lapses. Equation 1 shows that for each dollar of the average policy face value, the premium for ART policies is equal to the probability of death benefits being paid for an insured, discounted by the interest rate, and calculated annually.

For the 20-year term and whole life policies, we calculated a level annual premium for the duration of the policy, T. The duration of a whole life policy could be as high as 119[5] minus the age at issue, [1]. In practice, however, there is not a meaningful number of policies for insureds older than 95.[6] Premiums for whole life and term life are determined at issue, so the starting policy age used is equal to 1 (1+k-1 = k for the policy year in). Let K represent how many years the policy is going to last when it is calculated (min[95, 119 - age] for whole life and min[20, 119 - age] for term life). Premiums are set to be the same for all the years and are calculated so that the sum of the present values of expected annual premium payments (taking into account that the insured might die and stop paying the premium) equals the sum of the present values of expected death benefits for the duration of the contract. Thus, the premium for level-term and whole life policies is calculated using Equation 2

(2)

where S^k is the cumulative survival probability at policy year $+^k-1$.

The survival probability is calculated at the time a policy lapses for annual renewable term, or at the time a policy is issued for level-premium term and whole life. The initial survival probability is always equal to 1 (the insured is alive at the time of calculation). The age used in the calculation is the age when the annual premium is calculated. For an annual renewable term, it is the insured's age when the policy lapses. For level term and whole life, it is the age when the policy is issued. The cumulative survival probability S^k, is calculated as shown in Equation 3.

(3)

As shown in equation 3, $S^x{}_7$

where F_a and Fa represent the fractions of the three types of policies relative to all policies, and the average face values for each policy type, respectively.[7]

Finally, California specifies that prejudgment interest must be applied at 10% per year as simple interest.[8] We calculated the amount of annual interest charged on unpaid benefits under the *M H* decision by multiplying Equation 11 by 10%. We then summed the annual interest across years to get the cumulative interest.

4. Results

Our analysis yields compelling insights into the potential ramifications of the *M H* decision on the life insurance industry in California. Results appear in Table 1. Using data on the number of policies in California and the lapse rates and exposure matrix, we estimate that 2,636,991 individual life insurance policies lapsed in California between Jan. 1, 2013, and Aug. 30, 2021. Of these lapses, our model predicts that approximately 121,956 insured individuals had passed away.

Furthermore, we project substantial financial liability for life insurers in California. Our model (equations 1–11) estimates that the 121,956 policies that lapsed between 2013 and 2021, where the insured subsequently died, could create a $19.2 billion liability for life insurers in California. This liability is partially offset by $2.8 billion in premiums required to bring the lapsed policies current and cash value benefits that would be subtracted from the face values before the payment of death benefits.[9] Therefore, the estimate for the cumulative net benefit potentially owed by life insurers in California is $16.4 billion from 2013 to 2021. If insurers are required to pay prejudgment interest on unpaid net benefits, the total will be $22.4 billion (assuming a 10% simple annual interest rate, as per California law). Table 1 presents the estimates for the cumulative unpaid net benefits and interest potentially owed by life insurers in California.

Table 1: Cumulative Unpaid Net Benefit and Interest

Year		Cumulative Net Benefit	Annual Simple Interest	Cumulative Interest
2013	1	$ 300,039,608	$ 30,003,961	$ 30,003,961
2014	2	941,178,081	94,117,808	124,121,769
2015	3	1,955,480,827	195,548,083	319,669,852
2016	4	3,371,246,637	337,124,664	656,794,515
2017	5	5,224,636,992	522,463,699	1,179,258,215
2018	6	7,561,799,854	756,179,985	1,935,438,200
2019	7	10,419,992,585	1,041,999,259	2,977,437,458
2020	8	13,792,761,330	1,379,276,133	4,356,713,591
2021	9	16,399,802,891		

These findings underscore the significant financial burden imposed on insurers by the *M H. .* decision, with far-reaching implications for the stability and viability of the life insurance market in California. As stakeholders grapple with the fallout of this landmark ruling, prudent measures must be taken to navigate the complex legal and financial landscape and safeguard the interests of insurers, policyholders, and regulatory authorities alike.

5. Conclusions

In summary, the *M H. .* decision stands as a pivotal milestone that has significantly influenced the landscape of insurance law and policy, leaving a profound impact on California's life insurance market. The decision determined that the notice requirements preceding policy lapses applied to all policies in effect at the time. Consequently, many policy cancellations for nonpayment of premiums can be deemed incomplete, which may leave life insurers liable for death benefits on these lapsed policies. This has led to numerous class action lawsuits against life insurance companies. Our analysis sheds light on the substantial financial liabilities looming over insurers in the wake of this landmark ruling, underscoring the urgent need for proactive measures to mitigate risks and ensure the long-term sustainability of the industry.

Our findings offer actionable insights for both life insurers and policymakers. For insurers, understanding the financial liabilities associated with lapses affected bd[(kmyﬁ4sr)]T

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