

many insurance agents, do not clearly understand—especially the “dynamic” aspect of the interaction among the three key elements: 1) the policy’s face amount, 2) the policy cash values (reserves), and 3) the internal costs of insurance protection.

To understand NAR, you should think of it as if *you* were the life insurance company. In a term insurance policy, expenses and compound interest notwithstanding, policyholders are paying premiums based on the chances that they will die within the period of coverage. If they bought a one-year term policy, their premium reflects the chances of dying within that one-year period. If he or she renewed it in the following year, they would be a year older and the chance of dying would be a little bit greater, and each year thereafter the slope of the increase would become greater as they age.

The chances of a 35-year-old (with a life expectancy of probably more than 50 years) dying within the year are substantially smaller than the chances of death for an 80-year-old whose life expectancy would be 10 years or less.

If the policy was a 10-year level term policy, the chances are still very small that the 35-year-old will die between ages 35 and 45, and the premiums might not be that much higher than the average of what a one-year term policy would cost over those 10 years. But the chances that an 80-year-old will die between ages 80 and 90 are very high and much higher as he or she approaches age 90. The associated term premiums would need to be high enough to reflect the fact that many of them will die in year one when only one year’s premium has been paid and probably not that many will still be alive at age 91.

If you were the insurance company insuring a large group of 80-year-olds who each wanted to buy a \$100,000 policy—payable only if he or she died within the next 10 years—you’d know that some of them would die during each of those next 10 years, and that some of them would still be alive in year 11 and you wouldn’t owe them anything. They would have lost the bet.

If you simply thought, “I’ll charge each of them \$10,000 a year so that at the end of 10 years I’ll have recovered my \$100,000, which I will ultimately be paying most of their families as a death benefit,” you’d be ignoring the fact that a fairly large number will die in the first few years when you would only have collected

\$10,000 (one year’s premium), or \$20,000 (two years’ premiums), or \$30,000 (three years’ premiums). Using a mortality table showing about how many in each age group would die, you’d find that you would need to charge an annual premium that cumulatively over the 10 years would exceed the face amount of the policy.

This is the primary reason why permanent insurance was invented and why NAR is what makes life insurance affordable at the older ages.

Once again, pretending *you* are the life insurance company, you are now charging a permanent whole life insurance premium that, if you refer back to Figure 1, is considerably higher in the early years than the cost of the term insurance. You agree to pay back a portion of these overpayments to the insured if he or she decides to cash in the policy. Since you know you must have monies set aside for this possibility, you put them into the policy reserves, which are roughly equal to the cash values you will owe.

Now, since you already have set those monies—representing a portion of the face amount—aside, the amount that you would additionally have to come up with in the event of a premature death is *not* the entire face amount of the policy but instead is the *difference* between the face amount of the policy and the current cash value. This is the NAR.

In other words, if this were a \$1,000,000 face amount policy and the current cash value was \$100,000, the NAR (the pure death benefit amount) is only \$900,000 and not the full \$1,000,000. The beneficiary, of course, would still receive the full \$1,000,000.

Therefore, to roughly calculate how much you need to deduct from the policy’s cash value to cover the chances that the person might die that year, you’d take whatever the current cost per \$1,000 of term insurance face amount is for that particular age, sex, and risk class, and you’d multiply it times 900 (i.e. number of thousands of NAR), *not* times 1,000 (the full number of thousands for the face of the policy). This NAR times the current cost per \$1,000 amount would be deducted from the policy’s cash value. Insurance companies actually make this computation on a “monthly basis,” which is why you get an annual statement at the end of each policy year spelling out these mortality charges for each month, as well as showing how much interest was cred-

ited and what other expenses were deducted.

Once you understand that the company is only charging costs of insurance for the NAR, you can begin to see how permanent insurance or UL, when properly funded, makes life insurance affordable at the very older ages. Even though the term cost per \$1,000 of death benefit face amount becomes exorbitantly high at the older ages, the NAR is much smaller due to the cash value growth within the policy; thus, when you multiply the very high mortality rates times a very small NAR figure, the mortality costs that have to come out of the policy are still affordable.

So What Has Happened Over the Last 10 to 15 Years to Change Things?

When interest crediting rates remain lower than the rate when the policy was issued for a long period of time, unless the premium being paid was calculated using a lower and more conservative number than the current rate, chances are the current cash values in the policy are going to be lower than originally projected.

Once again referring to Figure 2, a lower interest rate (holding everything else constant) means that the cash value line representing cash accumulation would obviously be lower. When the cash value line is lower, assuming a level death benefit, then the NAR (difference between the face and the cash value) will be greater. At the younger ages, slight increases in NAR multiplied times the cost of insurance (COI) do not do that much damage to the policy's cash values (reserves). But, if things don't correct themselves, e.g., interest rates go back up or the COIs are decreased (highly unlikely) or if significantly more money is not deposited, the impact over time is cumulative. Figure 3 shows what happens.

Some persons may not be upset that, at the current premium level at which they have been paying for 10, 15, or 20 years, their current policy will run out of cash at age 85 and lapse unless they start putting significantly more money in or reduce the face of their policy. But many people would be, and many are not even remotely aware that this could happen. And with some, the underfunding problem is more serious, especially with some VUL policies.

The fact of the matter is that the sooner any potential shortfall is brought to a policyholder's attention, the

easier it will be to correct the problem, or to decide it isn't really a problem, or to make a change in the policy.

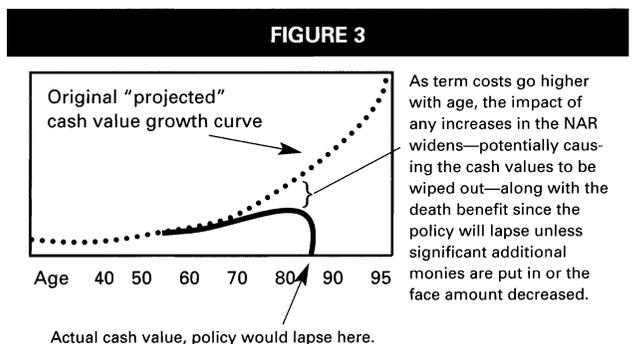
Although virtually *all* insurance companies have been impacted by the lower interest rate environment, some have also been affected by other factors that have made some segments of their UL business unprofitable compared with their original profit expectations. In order to adjust this, or in some cases to stop the bleeding, some of these companies have raised the COI rates inside the policies, in addition to dropping the current interest crediting rates.

Raising the COIs has a similar impact on NAR, as does lowering interest rates since, with higher term costs, more money has to be taken out of cash values to pay for the term insurance risk, resulting in a higher NAR. At the older ages, this can have an even more dramatic negative impact and put the policy in danger of lapsing even earlier.

These changes are invisible to the average consumer, and even most insurance agents would be hard-pressed to be able to calculate the level to which COIs had been increased. Some companies, on particularly unprofitable blocks of business, have dropped the interest crediting rate to the guaranteed minimum (3.5% or 4%) and raised the internal mortality charges to the maximum allowable within the policy, which could be two or three times more than what was originally projected.

What about Participating Whole Life Policies Sold during That Same Period?

A continuous-pay participating whole life policy with a guaranteed premium, guaranteed cash, and dividends paid on top does not face the same problems.



Although the dividends are not guaranteed and, often, dividends with many companies have been lower than originally projected, these dividends nevertheless have most commonly been applied to purchase paid-up additional amounts of insurance, thereby allowing the face amount of the policy to increase over time. The only impact here is that the original amount of total projected death benefit (with paid-up additions included) may be lower than originally anticipated.

But potential problems exist with some of these policies, which were sold with “blends” of permanent and term insurance to try and compete with the lower premiums, being proposed by agents selling lower premium UL products and VUL.

Generally speaking, blends of permanent and term insurance with a lower percentage of the total face represented by term insurance offer a lower risk than those with a higher blend of term. This has been somewhat offset in some cases by the use of paid-up addition riders to stabilize the policy design, but since commissions on that element were usually in the range of those paid on an annuity, you don't find many policies funded in this way.

As the policy's cash value built up along with paid-up additions, the amount of term insurance needed to keep the “total” death level (or even somewhat increasing) would decrease. In some cases with a large base amount of permanent and a low-term blend, the total face at some point in the future became totally permanent insurance.

But as agents and companies pushed the competitive envelope to compete for lower premiums to achieve a higher face amount, some of these low-base permanent-with-high-blends-of-term have also meant that some insureds are in danger of having their total death benefit reduced down to the guaranteed permanent policy base amount in the later years. This can be due to a lowering of the current dividend scales resulting in a need for more term insurance to make up the difference to keep the total death benefit level, or even raising the cost of the term insurance rates that are currently priced with a maximum guaranteed rate far above that originally projected.

Other Trends—Shrinking Agency Force

With the average age of an insurance agent in the mid- to late 50s and, according to LIMRA, approxi-

mately 70% of new-agent recruiting being done by only about 10 carriers, the agency force is declining at a disturbing rate. These aging sales force trends, combined with a dismal industrywide four-year new-agent retention rate of only 15%, further aggravate the problem of orphan policyholders with fewer agents to help monitor the condition of existing policies that have been sold. No one is there to monitor many of these policies and especially to warn policyholders of their underfunded status.

A New Potential Risk on the Distant Horizon

When companies price insurance products with intentioned profitability in mind, one of the most important components included in the calculation is a mortality assumption based upon statistical life expectancy. However, some lapse assumption should be kept in mind because many people who purchase a policy will lapse it prior to the time it would become a death claim.

At the younger ages, somewhat higher-than-expected mortality rates would be unusual, but it wouldn't cause that much of a problem barring, for example, a massive Avian flu epidemic striking young people in the picture of health and prime of their lives. The real damage could come at the other end with older-age insureds and larger policies.

With the advent of the viatical industry, later termed “life settlements,” insureds specifically targeted as prospects include individuals in poorer health with shortened life expectancies whose insurance may no longer be required, or whose premium-paying ability may make continuing the policy impossible.

When the life settlement industry was young, the purchasing of these policies with higher excess mortality posed no real problem. But, as the life settlement industry has grown with new players and with more agent awareness of a client in poor health who might financially benefit from selling a policy to a life settlement company rather than simply surrendering it, that could change.

With a permanent policy, the selling price to the life settlement company might be considerably above the cash surrender value. And with a term insurance policy, the benefit to the insured might be even greater since surrendering it would generate no cash surrender value, whereas the life settlement company might agree to pay

handsomely for it. The term policy premiums may have reached the end of the level premium period and become unaffordable to the insured just at a point where he or she has developed a severe life-shortening health condition. It would be hard to argue that this would certainly be in the insured's best interests, but strictly speaking from an actuarial viewpoint, in aggregate, this is impacting the way products are priced.

Down the road the problem could mushroom, impacting company profitability and even stability as well as causing pricing increases. This puts even more pressure on agents to monitor company stability and ratings when choosing a carrier as well as to pay more attention to industry trends and how individual companies are being impacted. (See further discussion about company ratings in the "Key Tips" section).

Shrinking Reinsurance Market

One final trend worth noting is the growth that has taken place in the amount of risk being ceded by life insurance companies to reinsurers. An estimate in 1993 suggested 15% of total life business written was ceded to reinsurers, and that number grew to 64% by 2000 and was projected to grow from there.² That fact, coupled with a shrinking pool of life reinsurers and a more critical attitude toward how closely the direct writer's underwriters follow reinsurer contractual underwriting guidelines, all have tended to tighten the underwriting within the marketplace.

Key Tips for Analyzing Existing Life Insurance Policies

The first and most important tool you need in order to analyze an existing permanent life insurance policy and alert your client to a potential problem is an in-force ledger. Here, you would typically request that the ledger be illustrated as the policy design was originally proposed such as full pay all years, limited pay number of years projected to carry the policy all years, etc.

The illustration will take the current premium, as well as the values in the policy, and project those values forward assuming current interest rate being credited and current cost of insurance charges being deducted. In most cases you should understand that the company could still move these closer or all the way to the minimum credit-

ing rate or the maximum mortality charges in the policy.

As you examine the in-force ledger, it would not be unusual to discover that a 15-year-old policy with a certain premium initially projected to make the cash value equal the death benefit at age 95 or 100 would instead show the policy lapsing when the individual is in his or her late 70s or early 80s, often prior to anticipated life expectancy.

Based upon what you see when this comes back, you can determine what makes the most sense:

1. Keep the policy as is and explain to the insured that the policy may not carry for his or her entire life (get this understanding in writing).
2. Increase premiums over the life of the policy (remember you could do this on a sliding scale instead of doing it all at once). You could also "dump in" additional monies from time to time. Once again though, the older the policy the more you should admonish the insured to consider the "guaranteed" column figures. As a result of some catastrophic event impacting the entire industry, or just some third-party aggregator trying to maintain some semblance of profitability within a block of business they've acquired—that has been severely selected against by most healthy insureds surrendering and thereby leaving only poorer risks—any additional "dump-in," even a large one, could be offset in the later years if crediting rates were reduced to the contractual minimum and mortality charges were raised to the policy's guaranteed rates.
3. Reduce the face amount of the policy, although you should be careful about some technical ramifications of doing this, especially in the earlier years.
4. Cash in the policy or replace the policy with another company. Remember, replacement of any existing insurance should only be done after a good deal of thought has been given to other alternatives. Also, make sure that there hasn't been a change in health, tobacco-use status, occupation, hobbies engaged in, or other situation that might impact premiums on a new policy.

People are living longer. Not only are we living longer, but many more boomers will be working well past normal retirement age, often just to maintain their current standard of living. Therefore, protecting income-producing power will still be needed in most cases.

Unlike the WWII generation, the boomers will be carrying debt loads into their retirement years—credit cards, home equity and installment loans, mortgage loans, etc.—and the need for having at least some base amount of permanent life insurance, whether it's traditional whole life, UL, or VUL that can be maintained well beyond the point when term rates become unaffordable, should become much more of a recommended strategy by financial planners and by media sources who, up to this point, have only suggested term insurance.

Maintaining some base amount of life insurance will be an additional safeguard in the future to offset unforeseen costs that other family members may have to assume such as the expiration of long-term-care benefits or some totally unforeseen consequences that could impact the entire industry—such as requiring a lower ratio of caregiver workers to seniors needing long-term care services or requiring more registered nurses instead of LPNs—which could upset the cost structure.

Some Newer Products and Programs Have Been Designed to Address Some of the Problem

Starting in the late '80s, some insurance companies began selling UL products with secondary guarantees in addition to those already standard within the contract (e.g., minimum guaranteed interest crediting rate and maximum COI charges). If a minimum specified premium was paid, it would guarantee that the death benefit would stay in force for some stated period of time (e.g., 10, 15, or 20 years) regardless of the actual interest credited or mortality charges deducted. In other words, the cash values could go to zero, but the policy wouldn't lapse during this guarantee period.

Over the next 15 or 20 years, policy no-lapse guarantees had been lengthened, and today many policies provide minimum premiums that, if paid, guarantee the death benefit to age 100 and even for life. What is important to understand, however, is that some of these products have conditions that, if not maintained during the entire life of the policy, can negate these secondary guarantees and make the policy vulnerable to lapse.

There is a service provided by Blease Research³ called "Full Disclosure" that compares many different features

of policies including these secondary guarantees. Agents need to understand the conditions under which the guarantee of the death benefit can be voided. The software covers all forms of permanent insurance including whole life, UL, VUL, and indexed UL, as well as all forms of survivorship life policies. There is a demo available for trial at www.full-disclosure.com.

Also, Profiles (www.profiles.com) offers a product called "Insurance Insight" that not only graphically helps illustrate the sensitivity within permanent life insurance policies inherent with changes in NAR, making it easier to understand, but also utilizes a powerful Monte Carlo simulation engine that uses actuarially certified industry-representative benchmark policy costs. This allows you to do "what-if" scenarios, which are especially valuable in analyzing VUL.

Something else that agents and brokers need to be aware of these days is the importance of doing due-diligence on companies. Although it's true that many of the companies that have been put into receivership had been, at one time, highly or even top rated not long before their downward spiral, many of these companies were "controversial" for some time previous to their demise.

Using top-rated or near-top-rated companies according to the rating services, e.g., A.M. Best, S&P, Moody's, Fitch, and Weiss, may become even more important when putting coverage into one of the guaranteed death benefit UL products since this is a higher level long-term mortality risk.

Conclusions

Many UL and VUL policies are in danger of lapsing long before they were originally projected to stay in force and decisions need to be made to rescue those policies where it makes sense, make adjustments to stabilize some, or to replace others when justified.

Some participating whole life policies with a high blend of term and a low base amount of permanent insurance are in danger of losing the term portion of the policy unless some remedial action is taken. Often, this internal term element has become prohibitively expensive versus competitive level term rates available in the marketplace, and, assuming there is no insurability problem, the term rider can be dropped and

replaced with a much less expensive level term policy or additional permanent coverage.

The shrinking reinsurance pool along with some adverse claims experience, especially on larger policies and at older ages, is causing reinsurers to be much more hard-nosed about insisting that their underwriting guidelines be followed by the direct writing company acting on their behalf with the underwriting authority given to them. The days of a “hand slap” and “please don’t do that again” are being replaced in some cases by the reinsurer denying liability for their portion of the claim, thereby dumping the full face amount back on the direct writing company. This is causing the entire underwriting marketplace to tighten up.

With a shrinking and aging agency force, fewer agents are available to service policies, and the pool of orphan policyholders has risen dramatically. In addition, qualified and trained insurance professionals, including CLUs, ChFCs, MSFSs, and especially CFPs, need to at least be aware of the underfunding problem and need to know how to order and analyze in-force ledgers and make appropriate recommendations.

Some of the new breed of UL policies with secondary guarantees can be used to solve problems involved with some of these underfunded policies, but agents also have to be aware of some of the potential “gotchas” that can negate the death benefit for life guarantees.

Other options, including life settlements, under the right set of circumstances may also be in the client’s best interests. ■

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- (1) *Life Insurer’s Fact Book 2006* (Washington, DC: American Council of Life Insurers).
 - (2) David Huntley, “Policy,” *Scottish RE*, No. 4 (January 2004).
 - (3) Blease Research, (877) 864-3833.

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