Tips for Evaluating Existing Life Insurance Policies

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Abstract: *Evaluating most existing life insurance policies can be a complex undertaking and requires a combination of different kinds and degrees of knowledge of product information, advanced underwriting tools and techniques, and how reinsurance works, as well as some degree of medical underwriting expertise. Much of this knowledge, especially product knowledge and the role reinsurance plays, can best be comprehended by having a better understanding of the evolution of the industry.*

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Back in the late 1960s, it was a very simple product world. There was term insurance—annual increasing premium (AIT), level premium, and decreasing term, and then there was permanent insurance—participating and nonparticipating whole life and limited pay life.

Then a damning Federal Trade Commission report in the early '70s claiming that the average return on permanent life insurance was 1.3% caused a flurry of denials and defensive claims of inaccuracies in the report by the industry, but it set the stage for an article presented at an actuarial conference in 1975 by Jim Anderson, president of Tillinghast, that is popularly known as *"The Cannibal Life Scenario."* This was the paper that formed the basis for the design of universal life (UL).

In his white paper, Anderson described a potential solution to the industry's dilemma; maybe *reaction* is a better description. His proposal was to take the basic design of all permanent life insurance—an increasing cash accumulation element and a declining risk element as the cash reserves within the policy built up over time—and compensate the "accumulation" piece more like that of an annuity and the "term insurance" risk element more like that of a life insurance product.

At a UL seminar I attended many years ago in Fort Worth, Texas, when the presenters got to the slides on compensation, two-thirds of the room got up and walked out. It seems that with the original proposed design, when you put the two components together again, the combined compensation was in the area of 35-40% versus the 55-70% agents were used to receiving. The first generation UL marketer's argument was

that they would be "cannibalizing" so much existing life insurance business that in the long run, the consumer would be much better off, and the agent would be as well, although the agent would have to sell a lot more to make the same income. And, as they say in Georgia, "That dog won't hunt."

But perhaps what is more important to recognize is that much of what launched UL was pure luck.

If you were around back in the early to mid-'80s and remember the hyperinflation we experienced, UL hit the market in the 1981-1985 period, near the height of the inflation curve. It was a very lucky coincidence for UL's introduction. At that time, some crediting rates for a UL product were above 13%, and agents were showing computerized illustrations with level premiums being solved based upon an interest rate assumption of 12% or higher and projected to stay there all years into the future. Agents showed "alternate rate" illustrations at 10 or 11% and felt this was being conservative. You can't completely blame agents when there were even economists who maintained that this was a new hyperinflationary world we had entered, and that we would never again see inflation in the 2-3% range.

Although the original UL product design with a significantly lower commission structure and much higher early cash values was being marketed by a few companies, most UL product manufacturers had now come to the realization that the product would only reach broad agent acceptance by retooling commissions. Gradually, the product evolved, although with higher loads and most with graded rear-end surrender charges penalizing persons who surrendered their policy in the early years and rewarding longer term persisters.

The first victims of massive replacement were traditional nonparticipating permanent policies with fixed guaranteed premiums and cash values but with no upside potential in that inflationary marketplace. Companies developed interest-sensitive products trying to stem the tide of replacements. Executive Life was one company that mastered this fixed-premium, interest-sensitive product line and became a major force in the industry until some miscues on the investment side with junk bonds took them under.

Participating whole life policies were impacted to a lesser degree, and most of us still around today remember the full-page ads in the *Wall Street Journal* by MassMutual's CEO saying they would *never* offer UL as a product. But "the times they are a-changing," and today, MassMutual carries both UL and traditional whole life products.

The next development was the evolution of variable life, first introduced in the mid- to late '70s but growing in acceptance in the later '80s and early '90s, especially with the advent of variable universal life (VUL). Here was the ultimate in shifting the risk to the consumer, and once again, in their exuberance, some agents were illustrating a 12% return—maximum allowed—and apologizing that with the historical performance of the market actually being higher, this 12% was "conservatively" all they could show. But, as we know, that certainly changed in the '90s and early 2000s, and some of these variable life policies sold then, as well as many traditional UL policies, are in serious danger of lapsing before their insured policyholder does.

Over this same period, between UL and variable, most traditional non-par products were replaced either externally or, in many cases, with in-house policy-transfer programs to try and conserve the business.

But before we move to the analysis part of the article, we need to be aware of trends that both impacted and continue to impact the industry, which, in turn, have impacted product design and performance.

Trend—Consolidation and Demutualization

At the end of the '60s, there were approximately 1,800 legal reserve companies, and the industry had about $1.4 trillion of life insurance in force. According to the American Council of Life Insurers, the number of companies rose to a record high of 2,343 in 1988, but by the end of 2005, there were 1,119 life insurance companies and over $18.4 trillion of life insurance in force.[1]

In addition to the shrinkage in the number of carriers, there has been a dramatic shift in the number of mutual insurers over to stock insurers. Back in 1950, mutual companies represented only about 8.6% of the 1,780 total U.S. life insurance companies, but they accounted for 55% of the ordinary life insurance in force. Today mutual companies actually represent a higher per-

centage of total number of insurers (12% versus 8.6% in 1950) due to mergers and acquisitions, but they only represent 17.4% of insurance in force versus 80% for stock companies. The remainder of total in-force life insurance resides with fraternal and other insurers.

The good news is that this consolidation has reduced operating costs and general overhead expenses, while at the same time it can be argued that much of those savings have been more than offset by increased expenditures on regulatory requirements and associated legal expenses, including a number of very expensive class action suits brought on by company and agent market misconduct issues.

Historically, mutual life insurance companies have tended to be at somewhat of a competitive disadvantage against stock life insurance companies with regard to access to capital. Whereas mutual companies need to generate their growth internally since, at least theoretically, the company is owned by the policyholders, stock life companies can raise money externally through sale of their stock and through the use of other financial instruments.

With rising competitive pressures being what they were, almost a decade ago and continuing today, many of the major mutual carriers began demutualizing and changing over to stock companies. What this has done is put more emphasis on the bottom line and especially on quarterly performance. Looking at it from another angle, some mutuals had been less driven by bottom line considerations because they had more excess revenue to work with. Today, stock or mutual, it's just a more competitive and aggressive environment.

This greater attention to the bottom line has encouraged many companies to look for ways to make existing blocks of business more profitable. In some situations, this has had an adverse impact on some blocks of in-force business in which profitability tends to erode over time for a variety of reasons, the most common one being replacement and adverse selection. If a number of policyholders, for whatever reasons, cash in or replace their existing policies, the ones who tend to maintain their policies are often persons who have had a change in their health and either cannot go elsewhere or can only get coverage at a much higher cost.

TABLE 1

Company	Total Assets (000s)
Metropolitan Group	$399,243,952
American International Group	341,117,984
Prudential of America Group	330,777,442
Hartford Life Group	204,499,522
Manulife Financial Group[a]	179,186,378
TIAA Group	177,926,824
AEGON USA Group	172,777,531
ING	170,277,336
New York Life Group	166,150,576
AXA Financial	133,887,669

Source: *Life Insurer's Fact Book 2006* (Washington, DC: American Council of Life Insurers): 94.

[a]This figure combines the total assets of Manulife and the John Hancock Group.

Trend—Globalization and Acquisition of U.S. Companies by Foreign Companies

The changes being driven by consolidation and demutualization are blending in with those tied to the increasing globalization of the insurance industry. Once again referring back to the early '70s, from a total-assets measurement the industry was dominated by Prudential and Metropolitan Life, with other major mutual carriers falling far below. Today, the list of top carriers from a total-asset standpoint is grouped much more closely and with a number of the global giants included in the top 10 mix (Table 1).

Trend—Impact of Lower Interest Crediting in Lower Interest Rate Environment

This, combined with a leaner and meaner financial landscape—with unprofitable blocks of business sometimes being "managed" for profitability—has meant that many policies projected to endow at age 95 or 100 (or to at least stay in force well beyond life expectancy) are now in danger of lapsing well before the insured does.

And what is most disturbing is that the majority of insureds whose policies are in danger of lapsing far earlier than they had anticipated, based upon what their understanding was at the time they were sold, are totally unaware of this.

This is primarily due to a lack of understanding of

how one of the most important elements of life insurance works: net amount at risk (NAR).

Understanding Net Amount at Risk

Prior to the introduction of UL, NAR was a much less understood concept since it was invisible within the actuarial design of traditional permanent life policies. Understanding net amount at risk is best explained using UL as the model.

Traditional whole life policies, also referred to as permanent life insurance, have a fixed premium, a guaranteed death benefit, and a set of guaranteed cash values. Most have dividends paid on top that, while not guaranteed, usually are paid, although not necessarily in the same amount as projected. Dividends may be used in a variety of ways (e.g. taken in cash, used to reduce premiums, etc.), but the most commonly used option is to allow the dividends to purchase additional amounts of paid-up life insurance. Therefore, when these dividends are paid over a period of time, the death benefit grows, as does the policy's cash value, since these chunks of paid-up insurance also have cash values.

UL policies, technically known as flexible premium adjustable life policies, allow for flexible premiums—within certain limits—and essentially stay in force as long as there is sufficient cash value in the policy to cover the expenses and the mortality costs for the life insurance inside the policy.

The majority of UL policies have been sold on the basis of being able to pay less than traditional whole life premiums and to have more flexibility both with premium payments and adjustability of the policy face amount—up or down.

The flexibility of the face amount is a valuable feature. The ability to pay less than what it would cost for the same face amount of a traditional participating whole life policy runs some downside risks of which most consumers, and even many agents, are not aware.

Whole life insurance was originally invented because term insurance, which pays only in the event of death, has premiums that go up each year as the person gets older (i.e. closer to life expectancy), and these premiums become prohibitively high for most persons in their 70s and 80s.

The slope of the increase of term insurance premiums per $1,000 of death benefit stays fairly level during ages 30 to 60, but then it starts increasing geometrically (Figure 1).

The level premiums on a whole life policy taken out from ages 30 to 40 would be substantially higher than the term cost in the early years with the overpayments (i.e. excess above the cost of term insurance) going into policy reserves to cover those higher costs at the later ages, but they would be substantially lower in the later years when the term costs skyrocket as the person gets closer to life expectancy.

In a whole life or UL policy, these excess payments, above and beyond what's needed to pay for the cost of insurance and expenses, build up as the policy's cash values.

Forgetting about dividends, Figure 2 shows what the guaranteed cash value building up inside a whole life policy might look like. The difference between the face amount of the policy and the policy's growing cash value is the NAR. When the face amount is level and the cash value increases, the NAR declines until, as you can see, at age 95 or 100 (varies with some policies) the face amount equals the cash value.

It is the NAR concept that most people, including

FIGURE 1

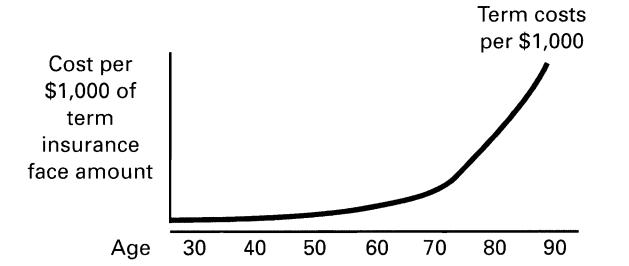

FIGURE 2