

**If you don't understand this,  
you don't really know what you're selling yourself into**

If you think selling life insurance got harder over the past two decades, hold onto your hat: there are more big storms coming. Here's some of the early warning signs.

- New York Life settles out of court on a \$65 million national class action suit claiming it misrepresented premium obligations in vanishing premium sales...and the premiums did not vanish. Among others, the Washington State Insurance Commissioner applauded the company for investigating complaints, setting tighter controls and servicing affected policyowners. The insurer admitted no guilt, but paid out of court.
- John Hancock faces allegations of engaging in “three separate types of schemes to defraud their customers,” again raising the vanishing premium issue. Prudential and other insurers face similar accusations.
- A number of new class action suits are now being filed against mostly the larger (deep pocket) insurers claiming “fraudulent schemes” and “misrepresentation of material facts” in the sale of their life insurance contracts.

What's the news here? *Certain attorneys have caught on to the games insurers play in the sales pricing of their products and how agents—at point of sale—may promise performance that is not guaranteed and in some cases simply not probable.* These attorneys are learning how to ferret out the truth of sales illustrations. They have begun to understand and uncover policy pricing assumptions, comparing sales illustrations to the realities of how the policy series are managed. This includes how in-force policyholders are treated relative to the illustrated assumptions they bought into, i.e., comparing the realities of the series' actual experience and management to the implied promises of the sales illustrations. These few, very aggressive attorneys dramatize certain problems the insurance business and its regulators have done little about. So far, the proposed NAIC

sales illustration regulations focus on curbing replacement, which is merely a part of a much larger range of sales illustration abuses.

What's the problem for you? *If you don't understand what you are selling based on true and accurate information from the insurers whose products you sell, and then inform your clients of the risks they face downstream with the contracts you recommend, you are going to be dragged feet first into the fire.* If you offer advice in risk management and know the products you are offering have certain risks based on undisclosed assumptions underlying the product, as well as the practices of the insurer regarding the treatment of its in-force block of business, then disclosing the risks in the product you are recommending to the purchaser becomes a professional obligation. If you do not know these things, you are selling something you do not understand.

Are we over-dramatizing? Read the rest of this article, test what we say, then decide for yourself. All we ask is that you make an informed decision.

**A few historical bullets**

A logical though insidiously dangerous progression exists in the thinking of life insurance companies regarding both the pricing of their products and the illustrative premiums they quote in their sales illustrations. Briefly, here's what has evolved.

- To make one company's product look better than the competition's, **product pricing began using assumptions that quickly became unrealistic**, i.e., inflated interest rates for UL and unrealistically high dividend scales for ordinary life.
- **Sales illustrations implied future values that past performance did not support**, i.e., the insurers' 10- and 20-year dividend histories and interest rates earned were, in their reality, substantially lower than their

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current sales illustrations suggested they would be in the future.

- In interest sensitive UL products, **the unrealistic interest rate assumptions in sales illustrations became relatively easy to debunk**. The reality of an insurer's actual interest earnings compared to the assumptions forecast in the sales illustration made buyers pretty savvy very quickly. Insurance companies did not like being so easily exposed, so they looked for other places to play the pricing and sales illustration game.
- **Vanishing premiums did not vanish**, and policies that buyers never dreamed would run out of cash values became nightmares for the insureds, then in turn for the people who had sold them, and then for the insurers who wrote the contracts. Either more premiums are paid or the policy lapses. Class action suits do not solve this problem for consumers; they just highlight it and feed the attorneys.

**The Shell Game**

Insurers explored new pricing assumptions in three areas where undisclosed assumptions are more difficult to expose: projected interest rates, projected lapse assumptions and assumed mortality. Of the three, **the cost of mortality has the biggest impact on illustrated premiums**, and is more difficult to debunk in the competitive sales situation—especially when it's there as an undisclosed assumption.

**A minor improvement in mortality creates a major lowering of premiums.** The CSO Mortality Tables are put aside. A new (*assumed* rather than guaranteed and rather than current) *illustrative mortality* is adopted—as an undisclosed assumption. Insurers claim that this pricing method is “supportable” because “improved mortality experience over the past 5 years can be compounded into the future” to

show the assumed, continuously compounded mortality improvement.

|  |
|--|
| <p style="text-align: center;"><u><b>A Sinking Fund</b></u></p> <p style="text-align: center;"><b>Premiums</b><br/>— plus —<br/><b>Investment Earnings</b><br/>— minus —<br/><b>Expenses and Profit</b><br/>— equals —<br/><b>Face Amount At Mortality</b></p> |
|--|

If you understand life insurance as a sinking fund, then you can easily see that this assumption of compounded mortality improvement significantly and often dramatically lowers the premium required. The sales illustration looks remarkable; too good to be true. So, for the brokers who take marketing and selling life insurance seriously, the questions to each of the insurance companies then become:

*If you presume improved mortality into the future and illustrated that you will pass on that gain to your policyholders, then:*

1. *Have you had mortality improvements over the past five to seven years?*
2. *If yes, have you passed the benefit of that improved mortality experience to your in-force block of business?*

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Let's look at an example of the effect on premium when a 45 year old's life expectancy is improved a bit at the point of sale (undisclosed assumption of improved mortality, for sales illustration purposes).

**Example: Male age 45, \$500,000 face amount  
10 payments, assumed interest rate 6.25%**

| Life Expectancy | Age | Required Premium |
|-----------------|-----|------------------|
| 35 years        | 80  | \$ 7,295.        |
| 39 years        | 84  | \$ 6,082.        |
| 43 years        | 88  | \$ 4,772.        |

If the insurer sells the lower premium based on assumed improvements in mortality, yet maintains a higher mortality charge for the management of the policy series, then higher premiums will have to be charged eventually or the policy series will not be profitable.

We've asked several companies if they will reduce the mortality charges in their policy series if they actually experience their illustrated, assumed mortality improvements, and thus pass on the benefit to the people they sold it to. We know of no company that has reduced the mortality charges on its in-force block of business. Some say they are considering it, but none we know of have yet done this. We expect that any company that does this will shout it from the mountaintop.

**What if...  
the assumptions do not come true?**

Companies that project improved mortality as undisclosed assumptions, and then do not experience the assumed improvement in mortality, create great risk to the policyholder that the contract will run out of cash value or reserve. Then, just to keep the insurance in force, the policyholder must pay it as yearly renewal term at ages that will probably make the cost prohibitive. The economics also do not pan out very well at all. Let's see how and why.

Example: \$1 million insurance runs out of CV (cash value) at age 77, so the first YRT premium is \$44,160. The next year: \$48,360.

**A sample scenario**

Now the bad news: the insurer actually experiences improved mortality but does not pass the benefit on to its in-force block of business (they're probably using it to support new sales), and the insured lives to age 87. That year's cost is \$111,000. premium. Imagine: the total cost of premiums for the 11 years from age 77 to 87 is \$753,898! Add that to the previous payments made and figure what the policyholder must put out for a \$1 million death benefit!

**Identifying unrealistic  
illustration assumptions**

There are compelling reasons for you to be able to spot and call to the table the unrealistic sales illustration assumptions that make risk and speculation in life insurance pricing potentially dangerous for the consumer, yourself and the insurance business. The first is your pledge to always put first the needs of your trusting clients. They count on your professional (unbiased) advice. The last is your integrity and professional ethic, which must remain intact. We leave all the other reasons in between these two for you to decide, even if it is simply to know what you sell.

Want to understand what happens a life insurance policy where the sales illustrative premium is based on an undisclosed assumption that reality does not support? First, in an actual sales illustration, work the number out to older ages (ages 75-plus or 80-plus).

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| Age | Gross Annual Outlay | Cash Surrender Value | Death Benefit |
|-----|---------------------|----------------------|---------------|
| 80  | 41,047              | 961,233              | 4,350,000     |
| 81  | 41,047              | 1,055,899            | 4,350,000     |
| 82  | 41,047              | 1,155,179            | 4,350,000     |
| 83  | 41,047              | 1,259,135            | 4,350,000     |
|     |                     |                      |               |
| 87  | 41,047              | 1,725,445            | 4,350,000     |
| 88  | 41,047              | 1,859,565            | 4,350,000     |
| 89  | 41,047              | 2,002,402            | 4,350,000     |

\* Projected interest rate 5.50% plus 1% bonus for a total of 6.5%

Next, determine mortality and administration charges.

**Determining Mortality & Administration Charges**

|   |           |
|---|-----------|
|   | \$        |
| Age 80 CSV (cash surrender value)                 | 961,233   |
| Plus Gross Annual Outlay                          | 41,047    |
| Total   | 1,002,280 |
| Plus Interest @6.5%                               | 65,148    |
| Total   | 1,067,428 |
| Less Age 81 CSV                                   | 1,055,899 |
| Equals cost of mortality & administration charges | \$ 11,575 |

The amount of insurance is \$3,294,101, which is the \$4,350,000 death benefit minus the \$1,055,899 cash value. The illustrative cost of mortality and administration charges total \$11,529. Compare this amount to the \$68,155 term cost at age 80 for the P.S. 58 term equivalent of a representative company, or the \$139,813 age 80 current mortality cost for a representative quality company, and you will see the dramatic differences between what can be illustrated for sales purposes and what is much more likely to occur over the long term. The low-ball sales illustration premium simply cannot be justified.

The illustrative cost of insurance at ages 87 and 88 are similarly low.

|                                |              |
|--------------------------------|--------------|
| Age 87 CSV                     | \$ 1,725,445 |
| Plus Gross Annual Outlay       | 41,047       |
| Total                          | 1,766,492    |
| Interest @6.5%                 | 114,322      |
| Total                          | 1,881,314    |
| Less Age 88 CSV                | 1,859,565    |
| Illustrative Cost of Insurance | 21,749       |
|                                |              |
| Age 88 CSV                     | \$ 1,859,565 |
| Plus Gross Annual Outlay       | 41,047       |
| Total                          | 1,900,612    |
| Interest @6.5%                 | 123,540      |
| Total                          | 2,024,152    |
| Less Age 89 CSV                | 2,002,402    |
| Illustrative Cost of Insurance | \$ 21,750    |

Compare these costs (Company A's) based on illustrative mortality to costs based on current mortality by another quality (highly rated) company (Company B). The premium based on current mortality is \$56,039 for "B" vs. the \$41,047 for "A" based on the illustrative mortality. However, let's also compare the cost of mortality and administration charges between the two companies.

**Current Mortality-Based  
Sales Illustration—Company B**

|  |              |
|--|--------------|
| Age 80 CSV                                   | \$ 1,992,345 |
| Plus Gross Annual Outlay                     | 56,039       |
| Total  | 2,048,384    |
| Plus Interest @7.75%                         | 158,750      |
| Total  | 2,207,134    |
| Less Age 81 CSV                              | 2,079,270    |
| Cost of Mortality and Administration Charges | \$ 127,864   |

If you bought on the basis of the sales illustration, you would buy from the company selling the cheapest rate (Company A). However, the cost of buying the better illustrated product will be astronomical in the long run because there is no way the insurer can support their long-term mortality charges. Higher premiums will have to

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be charged down the line, probably at the very time the policyowner can least expect it. Something will have to give, and it will most certainly be the consumer.

If you can explain the reasons for buying the more realistic proposal, pointing out these types of risk-raising problems in sales illustrations and contractual rights of the insurer to raise premiums in policies increasingly built in favor of the insurer and putting the consumer at risk for the undisclosed assumptions, you can win the support of buyers and their other professional advisors. You can also avoid future litigation when you do this and keep a record of your recommendations in your client file.

And you might as well get used to it. In the near future you will probably have to do this anyway (perform Due Care). Remember: ***In marketing you can be first and you can be best...but it is best to be first.*** Will you embrace performing Due Care as a procedural standard for determining the suitability of a life insurance offer to a client, or will you be dragged into it kicking and screaming only when you can no longer avoid it?

**Things to Consider**

- **Not all companies are bad.** There are several high quality insurers that do not play such risky sales illustration games. They treat their in force policyholders fairly, or at least intend to. You will find these companies when you perform Due Care, just as you will find those that will continue to play sales illustration games and put policyowners at risk.

To start, you need to closely examine the insurer's performance history. **It is more important to observe what the insurer has done than what it illustrates it will not do.** Examples of company dividend payment histories versus what they projected in their sales illustrations follow. On the basis of actual performance versus promise, which one

would you be most comfortable recommending to your clients?

**10 year Dividend Comparison  
Actual vs. Projected**

|             |        |
|-------------|--------|
| Company "A" | -28.2% |
| " B         | -42.8% |
| " C         | -62.7% |
| " D         | -10.4% |

Please Note: Some brokers—when comparing companies—reduce every company's dividend scale by the same level to observe what happens. Based on the preceding examples, this does not really seem to make sense. Integrity means you walk your talk. Some companies do what they say they will do; others don't. Dividend and interest histories do not lie, and they are very likely to repeat themselves because they are management decisions. Which company do you want backing you and your clients?

- An insurer uses mortality improvements to support current illustrative pricing, yet upon examination you see they raised their mortality charges for their in force closed block of business even though they experienced mortality improvements over the last five years. How can you believe that they are going to pass on future mortality improvements based on their historical actions?
- An insurer's current U/L illustrations indicate that they have one of the best products, yet when you observe A.M. Best's 10 year history of U/L this same company is ranked in the bottom five percent of performance. Why would you think this company's performance will improve in the future?

### **What Are Your Options?**

The way we see it, you have three options:

1. **Sit and wait.** You can hope that all this Due Care stuff will pan out when the NAIC clamps down. Why bother now? Besides, none of your clients would sue you anyway, right? And you have plenty of E&O coverage.
2. **Learn how to perform Due Care and life insurance risk management.** Learn about insurance contracts, the nature of the product and its many variations today, and how to compare one contract's suitability to another's for your client. Learn the problems with sales illustrations based on undisclosed assumptions, and point them out to clients, attorneys, accountants and trust officers, so they will come to rely on you to help think through important insurance decisions.
3. **Retire.** The business is getting harder just at the time you want to be working easier, so make your move sooner, not later.

Hopefully only one of these options suits you, and you will take the next steps necessary to remain a leader as the business and consumer interests evolve.

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