LIFE INSURANCE ADVISORS, INC.
FEE-ONLY INSURANCE CONSULTING
714 E. PROSPECT AVENUE • LAKE BLUFF, ILLINOIS 60044
PHONE (847) 482-1605 • FAX (847) 234-9973
david@lifeinsuranceadvisorsinc.com

Why You Should Question Life Insurance Policy Illustrations

by
David N. Barkhausen

In analyzing the possible rate of return of either a new or existing life insurance policy, and comparing it to possible alternatives, it is first important to understand how inherently unreliable and potentially misleading is the most common method of analysis -- the policy illustration prepared by the company or agent.

Sellers of life insurance policies, including products with an investment component, are allowed to do that which is illegal for the seller of securities -- to project into the future the likely rate of return of a particular policy and to represent that the illustration is a sound basis for selecting the product.

To even pretend that the illustration accurately portrays how the policy will perform is potentially even more misleading than if similar sales materials were allowed to be used in the sale of mutual funds, since the life insurance policy is more complicated than a mutual fund, and its future rate of return is therefore more difficult to predict. While the mutual fund's performance depends only on the gross rate of return of the investment and money management expenses, the life insurance policy's return is tied to four factors -- investments, mortality experience, expense charges, and lapse rates of policies (how long they stay on the books). Does it make sense that projecting the future performance of the relatively uncomplicated product (the mutual fund) is illegal, while doing the same thing for the more complex product (the life insurance policy) is not only legal but is the primary basis upon which agents sell and consumers choose among competing products? Obviously not. Indeed, the practice defies logic and invites deception.

How well a policy performs and how close it comes to meeting or exceeding its illustrated rate of return depends on the non-guaranteed performance of the company and policy in all of the areas affecting rate of return, and the current results do not always justify the manner in which these factors are implicitly shown to play out in the future in a policy illustration. In other words, the future forecast may look much brighter than the past. The experience of the life insurance industry makes clear that there is no very close correlation in most cases between companies that illustrate most optimistically and those that have performed well.

Confirming the widespread abuses in life insurance policy illustrations is the 1996 Tillinghast-Towers Perrin study of the subject. According to their analysis of the illustrations from 114 companies, only 50 percent met the standards for illustration integrity proposed by the National Association of Insurance Commissioners (NAIC). Most revealing, only 2 of the 28 illustrations purporting to show the best future projections passed the NAIC test. What this means, quite obviously, is that, in spite of good faith regulatory efforts, life insurance illustrations are almost certain to be a hopelessly flawed basis for choosing the company and policy that will likely perform most competitively in the future.

Misleading assumptions of life expectancy: The widespread problems with life insurance policy illustrations result, more often than not, from overly optimistic projections of life expectancy. They are not based on the insurer's current experience but on future gains in life expectancy that may not occur.

That the performance of a life insurance policy fluctuates with changes in the insurer's investment experience would seem obvious. But its dependence on other factors, especially a company's mortality charges, is likely a revelation to those who don't make a living as actuaries. Did you know, for example, that a 20% increase in the level of assumed mortality and expense charges in an illustration might reduce the policy's rate of return by a full 100 basis points (1%)? That has a big impact over the life of a policy.

While it is possible for the sophisticated consumer or professional advisor to judge whether the investment expectations underlying the projected performance of a life insurance policy are realistic, there is no ready ability to determine the mortality assumptions, much less whether they are reasonable. Nor does the agent have any control over the assumptions used. Unlike the investment assumption, which can be changed by the agent in different illustrations, the mortality and expense assumptions are embedded in the illustration and cannot be altered.

The inscrutability and immutability of life insurance mortality and expense charges masks the most disturbing fact about policy illustrations - the hidden and widespread use of unrealistically low mortality charges in the later years of a policy to make it look much better than it otherwise would. This abusive practice allows insurers to play the "illustration game," showing either more death benefit for a given premium or a lower premium for a given death benefit. More than ever, it makes illustrations a completely unreliable basis for predicting policy performance and for choosing one insurance company over another.

Actuary highlights abusive practices: These practices have drawn public criticism in an unlikely forum. The July 16, 2001 National Underwriter, a leading insurance industry periodical, carried an article by a company actuary entitled, "Low Mortality Assumptions Could Hurt Buyers' Confidence in Life Industry." It characterized "the increasing use of very low mortality assumptions in the 'out years' of sales illustrations"…as "rooted more in science fiction than science" and motivated by the fact that the practice makes companies' "sales illustrations look great…(I)nsurers that base their illustrations on more moderate mortality assumptions…are losing sales to insurers that attract buyers with aggressive assumptions." In some cases, companies are implicitly assuming annual rates of improvement in mortality experience that are "300% to 400% of the rather impressive rate that the industry has enjoyed over the last 15 to 20 years."

How can one respond to this state of affairs?

1. Do not base life insurance investment decisions on policy illustrations.

To the extent possible based on underwriting results, choose "permanent" life insurance (e.g., whole life, universal life, variable life, and combinations thereof with term insurance) from the company or companies that offer the best combination of strong financial strength ratings and top historic rates of return. Do not select one company over another because the preferred company's illustration shows a lower premium for the same death benefit or more death benefit for the same premium. That appearance may simply be a function of more aggressive and unrealistic non-guaranteed assumptions with regard to life expectancy and other factors.

2. Look out for underfunded "permanent" policies that may lapse (i.e., fall apart).

Much existing insurance has been purchased based on perceptions of lowest price. The combination of lower interest rates and higher mortality and expense charges than those assumed in the policy illustration will cause most of these policies to fall apart if the insured (or the survivor of two insureds in the case of survivorship policies) lives a long time. (For more details, see our separate article, "How to Avoid the Premature Death of an Existing Permanent Life Insurance Policy").

Possible corrective action includes: (1) pay a higher premium, (2) reduce the death benefit, (3) seek the internal modification or replacement of the policy with the existing insurer without new underwriting, (4) replace the policy, if health factors permit new underwriting with acceptable results, with a new policy that can be expected to offer a better long-term return.

3. How can one detect unreliable and misleading policy illustrations for either new or existing insurance?

Not easily, but it is crucial for both new and existing policies of any size because of the widespread problems discussed above. One must first determine the implicit assumptions behind an illustration, compare them to some benchmark rate, review historical company data to determine any appropriate adjustments, and rerun the original illustration with a weighting factor based on these findings. We call this process the "reverse engineering" of a life insurance policy illustration. It is a key part of our business. Agents and brokers cannot perform this function because they have no ability to adjust the mortality and expense assumptions in their illustrations. (For further details, see pages 21-22 of our article, "What Sophisticated Investors Should Know and Ask about Life Insurance").

4. Does that mean the client has to engage you and also pay the regular commission to the insurance agent or broker when buying new insurance?

Ours is a fee-only consulting service. We do not receive any portion of commissions. Where we can oversee the purchase of new or replacement insurance, we can very often reduce standard commissions from cooperating agents by 80% or more on the best life insurance products. These savings are several times the amount of our fees in such cases and substantially increase the long-term returns of the new or replacement insurance. (For further information on this point, see our separate article, "How to Reduce Commissions by 80% or More on Life Insurance from the Best Companies").

David N. Barkhausen is President of Life Insurance Advisors, Inc., a fee-only life insurance consulting firm. He was previously an agent with Northwestern Mutual Life from 1991-1998 and was the company's top first-year agent in 1991-92.

An estate planning lawyer prior to joining NML, Barkhausen is a member of the American, Illinois, and Chicago Bar Associations and the National Conference of Commissioners on Uniform State Laws. He has written for and spoken to these organizations on estate planning and life insurance topics, and he has also conducted Continuing Professional Education seminars for the Illinois CPA Society on the business and estate planning applications of life insurance.

Barkhausen graduated with high honors from Princeton University in 1972 and in the first class of the Southern Illinois University School of Law in 1976. He and his wife, Sue, live with their sons, Wicks and Billy, in Lake Bluff, Illinois.