

An Examination of IMSA' s Effectiveness

Reviewing the Industry's Buy Term and Invest the Difference Presentation

****Written in 2001** By: Brian Fechtel, CFA & Agent

Many within the life insurance industry take pride in the industry's efforts to prevent sales practices problems similar to those of the 1980s and 1990s from reoccurring. All leading life insurers have large compliance departments and reevaluated all marketing materials. In 1996, the industry established the Insurance Marketplace Standards Association (IMSA), which promulgated principles of good practice. Principle #1, for example, requires insurers to "conduct business according to high standards of honesty and fairness and to render that service to its customers which, in the same circumstances, it would apply to or demand for itself," often called its Golden Rule Principle. In 1998, IMSA began awarding its seal of approval to insurers that demonstrated adherence to its six principles and many practices. Now (again, this was written in 2001), in anticipation of the IMSA required triennial recertification, many insurers are currently conducting their own internal audits. Consequently, this seems a good time to evaluate the effectiveness of IMSA and its spawned compliance procedures. To do so, a most popular sales tool, a Comparison of Buying Whole Life with Buying Term and Investing the Difference, is reviewed.

Reviewing the Whole life vs. Buying Term and Investing the Difference Comparison

Discussion of the alternatives of buying whole life or buying term and investing the difference (BTID) is inevitable in many sales situations. Consequently, the insurer-prepared spreadsheets comparing these two alternatives (shown below in Exhibit A) can be one of an agent's most valuable sales tools. Observe that the total outlays to both alternatives are the same; that is, the annual premium for the whole life policy (shown in Column 1 – column number shown across the top of the table) is equal to the combined outlays for the term insurance (Column 2) and the difference that could be separately invested (Column 3) in a side-fund. Column 4 contains the year-end balance in the investment side-fund based on assumptions on the side-fund's annual after-tax investment return. Note, these side-fund investment assumptions are shown atop the spreadsheet comparison. Columns 5 & 6 show the Illustrated Total and Guaranteed Cash-Values for the whole life policy. Column 7 shows, for a few select years, the pre-tax rate of return required for the stream of Annual Differences (Column 3) to grow in to the illustrated Total Cash-Values (Column 5). Columns 8 & 9 show the two policies' death benefits.

Comparison of Cash Values

The asterisks in year 14, as stated in note 6, reads: "The Permanent Policy's cash-value exceeds the difference compounded at A/T [after-tax] rate in [this] year." This note facilitates agents describing Year 14 as the break-even point. But, is that correct? Is this comparison appropriate? Column 4's value is an after-tax, liquid amount while Column 5's is pre-tax and not-entirely-liquid value. Furthermore highlighting this certainly promotes the conclusion that as long as the consumer would want coverage for 14 years, he or she should prefer whole life. Appropriate disclosure, it would seem, would require identifying instead the years during which the side-fund equals: a) the after-tax value of the policy upon surrender, and also possibly b) the maximum amount that can be borrowed against the policy. Of course, identifying such longer break-even points is contrary to agents' and insurers' objectives. But without such information, what consumer would readily realize that in, this supposedly helpful illustrated comparison, the policy's after-tax receipts if surrendered at age 60 would still be less than the side-fund?

Comparison of Total Proceeds At Death

Based on the below spreadsheet comparison, which alternative in year II would provide the greater sum to one's beneficiaries, and by how much? Although the side-by-side comparison of Columns

Exhibit A

\$300,000 Whole Life policy compared with Term Insurance
with differences in premiums invested at 7.50% (39% tax bracket)
For Male Age 40, Premium \$5,592

Non-Guaranteed Dividends Used to Purchase Paid-Up
Additions

	1	2	3	4	5	6	7	8	9
	Annual	Term		Difference	Permanent Policy		ROR on	Amount	Perm'n't
	Prem.	Policy	Annual	Comp'nd'd	Cash Surr. Values	Guar.	Col 3 to	of Term	Policy
<u>Year</u>	<u>Outlay</u>	<u>Payment</u>	<u>Dif'r'nce</u>	<u>@A/T Rate</u>	<u>Total*</u>	<u>Guar.</u>	<u>Col 5*+</u>	<u>P'rchas'd</u>	<u>Insurance*</u>
1	5592	296	5296	5539	0	0		300000	300000
2	5592	317	5275	11309	4421	4176		300000	300837
3	5592	347	5245	17312	9317	8475		300000	302774
4	5592	371	5221	23565	14711	12888		300000	305791
5	5592	395	5197	30079	20642	17427		300000	309861
6	5592	419	5173	36867	27140	22083		300000	314980
7	5592	443	5149	43940	34255	26888		300000	321136
8	5592	470	5122	51309	42022	31782		300000	328311
9	5592	500	5092	58984	50492	36829		300000	336508
10	5592	533	5059	66977	59732	42006	4.17	300000	345782
11	5592	566	5026	75300	69801	47319		300000	356145
12	5592	605	4987	83964	80657	52758		300000	367388
13	5592	650	4942	92978	92347	58314		300000	379532
***14**	5592	701	4891	102352	104884	63981	7.50	300000	392516
15	5592	758	4834	112095	118328	69753		300000	406383
16	5592	821	4771	122218	132727	75624		300000	421139
17	5592	896	4696	132727	148147	81600		300000	436799
18	5592	989	4603	143620	164636	87884		300000	453338
19	5592	1109	4483	154886	182254	93885		300000	470740
20	5592	1262	4330	166508	201058	100200	10.12	300000	489001
@60	5592	1262	4330	166508	201058	100200	10.12	300000	489001
@65	5592	2522	3070	229291	316232	130095	10.90	300000	608681
@76	5592	0	5592	390849	744400	194112	11.66	0	1033210

- Notes
- 1 Term outlays are based on new issue Term to Age 75 - Increasing Premiums.
 - 2 Term Policy Death Benefit does not include values shown in col.4.
 - 3 Amounts in Col. 8 are for illustrative purposes only.Amts below company minimums will not be issued. Changes in the amounts in column 8 are subject to Company practice.
 - 4 The Term outlay exceeds the Permanent Policy outlay in year 32.
 - 5 Rate of Return needed before tax, assuming a marginal tax bracket of 39%.
 - **6 Whole life cash-value exceeds the difference compounded at A/T rate in year 14.

*Non-guaranteed illustrated values & benefits include dividends. Dividends assume no loan; loans may reduce dividends. Illustrations reflect current (2001 scale) claim, expense and investment experience, and are not estimates or guarantees of future results. Dividends actually paid may be larger or smaller than those illustrated. This illustration does not recognize that, because of interest, a dollar in the future has less value than a dollar today. 8% loan provision. Submitted by Agent on 4/10/01

8 and 9 facilitates concluding that the Whole life policy would provide \$56,000 more, it is the BTID alternative with its benefits equal to the side-fund plus the term amount that actually provides the greater sum. In particular, note the omission in the heading to Column 8 of a symbol to direct the consumers' attention to relevant notes below. And while consumers can avoid making such an erroneous conclusion and agents can prevent such, when a con-man's credo ('use perception to facilitate deception') is recalled, it is difficult to call this comparison consumer-friendly. Nonetheless, IMSA and the life industry accept the above spreadsheet as a suitable and non-problematic comparison of the alternatives. In contrast, the NASD (now known as FINRA), requires such comparisons of a variable life policy to include an additional column showing the sum of the term insurance and the side-fund so that the above potential mistaken impressions and comparisons are prevented.

Few consumers understand the extent to which the whole life policy's smaller death proceeds in the early years contribute to its comparatively larger cash-values in the latter years. While most insurers' software enables correct, modified comparisons to be made where the total proceeds upon death of the two alternatives are equalized for as many years as possible, few agents show such comparisons. After all, the necessary modifications make the side fund's values comparatively more attractive which is contrary the agent's self-interest of selling the whole life policy with its larger compensation. Admittedly, this modification has a relatively small impact and makes for both more complicated sales presentations and term policy adjustments to continually change its amount. But given that it is the agents' choice to use these comparative spreadsheets instead of a more consumer-friendly conceptual presentation of the advantages of cash-value products, it would seem to be the industry's responsibility to unmistakably acknowledge this exercise of self-serving discretion.

A Few Important Other Observations about the Comparison

Does anyone think disclosure that the policy's performance is based on the "current scale" is meaningful? How can consumers assess the comparative impact of a side-fund's numerically explicit return with that of an undisclosed "current scale?" Despite life insurers' longstanding opposition to traditional whole life policies being perceived as investments, it cannot be denied that assumptions about investment returns underlie illustrated whole life policy values. While assumptions about other factors comprise whole life policy's dividend rates, the assumed investment return is a paramount factor. Would a comparison of real-estate investments be fair and meaningful when the valuation assumption of one alternative is an explicitly disclosed rate whereas this assumption for the other alternative remains undisclosed? Given that an advantage often considered persuasive arises from the difference between assumed investment returns, such wanton presentation constitutes insufficient disclosure. Indeed, use of the non-quantified "current scale" by portfolio insurers is shocking as it would seem an invitation to rogue agents to misrepresent comparisons between current bond yields and the "current scale" as fair because both are current, and yet many insurer's current scale is not a comparable, marked-to-market rate.

Interestingly, the NASD/FINRA requires that comparison of a variable policy with the BTID alternative be based on the side-fund earning the same gross pre-tax rate of return as the variable policy's sub-account. While this could be considered something of an improvement to the life industry's practice on its traditional products, the NASD/FINRA's straitjacketed approach has its own unique problems. For example, the NASD/FINRA prohibits the side-fund's rate of return from being reduced by any investment management costs. Would any competent and credible financial analyst ever build and present a similar comparative model of alternatives without providing the capability to include such real-world factors as investment management costs? Furthermore, the NASD's strait-jacket prevents agents from modeling a client's actual current investment behavior with that of a variable policy's sub-account with a superior risk-adjusted return on the investment efficient frontier. While perhaps enacted in a spirit of doing good, this NASD/FINRA rule is paternalistic, clearly unfair, excessively restrictive. Meaningful

BreadwinnersInsurance.com

and fair disclosure, not simplistic, misguided prohibitions, should be the objective for both the life industry and the NASD/FINRA.

Observations Regarding Supplemental Presentation Materials

Insurers also provide supplemental graphs and summaries to aid agents in presenting the advantages of whole life. These summaries, masquerading as objective, cast aspersion and make lopsided arguments with reiteration and half-truths. For example, "Potential Pitfalls of BTID"(Exhibit B) states, "The increasing cost of the premium could erode the side fund." Although true, it is also true that the increasing cost of coverage in a whole life policy can erode the earnings on the policy's cash-value. And, premium loans and larger premium taxes in the early years can and do erode the whole life policy's net cash-value. All are erosions of similar type and consequence, yet this summary with its clever, biased title (note that the insurer does not offer the "Potential Pitfalls of Whole Life") carefully omits such information. Similarly, the summary states, "Term insurance may expire prior to death," again omitting, not surprisingly, the more statistically and financially significant fact that the whole life policy may be surrendered prior to death and/or prior to its after-tax value exceeding that of the side-fund. While all presentations involve selective editing of information, such specious, self-serving, presentations hardly qualify as Golden Rule treatment. It seems it would be worthwhile to have a knowledgeable and independent group review such presentations. State regulators, of course, are supposed to have provided such, but perhaps it is time for another body to perform such work.

Exhibit B

The Potential Pitfalls of Buying Term and Investing the Difference

- Term insurance may expire prior to death.
- Term insurance premiums increase with age.
- There is often a need for insurance at older ages, when term insurance premiums could be prohibitive. The increasing cost of the premium could erode the side fund.
- You may need insurance at older ages for estate preservation, basic death benefit protection, and for maintaining your family's standard of living at death.
- In many cases, the growth in the side fund is taxed as annual income.
- Transfers between investments are often taxable, cause you have to recognize gain.

Conclusions

This review unfortunately shows continuing serious market conduct problems. While the industry no longer has problems with "vanishing" premiums not vanishing, this review shows that IMSA principles have not actually been implemented. Gerry-rigged analyses that omit necessary information hardly satisfy Golden Rule treatment. Presenting information in a manner that arguably facilitates misconceptions, emphasizes one-sided half-truths, and highlights insignificant yet potentially misleading facts can not constitute genuine compliance with IMSA Principle #I. Similarly, presentations based upon unacknowledged self-serving discretionary assumptions do not fulfill buyers' expectations of objectivity, fairness, and balance, especially after insurers have informed consumers that they will be treated just as they would like to be treated. And needlessly complex presentations, although very professionally delivered, are not respectful of the common man's aversions to being hoodwinked and demands for straight talk. Although these are sad answers, a path of genuine reform is provided below. After identifying the industry's refusal to reconcile critical dilemmas as the cause of this regrettable situation, this article aims to inspire industry executives by recalling that the best way to succeed is to solve problems, and that the best way to predict the future is to create it.

Industry Refusal to Reconcile Dilemmas Prevents Appropriate Disclosure

Genuine and meaningful disclosure of the whole life vs. BTID comparison reveals facts, it seems, that the life industry prefers remain unexamined. As long as anyone can recall, life insurance selling has BreadwinnersInsurance.com

relied upon building distinctions between term insurance and whole life. For example, term insurance is disparaged; it's renting, it's throwing money down the drain, it becomes "prohibitively" expensive. Agents claim whole life does not suffer these term characteristics/problems, and have long benefited from selling against these characteristics considered anathema. But anyone who understands whole life knows it has all of these same characteristics. Even the "Buyer's Guides" which the regulators have authorized, although largely unused, require revision because of the priceless endorsement they provide in stating that term and whole life are *different types* of life insurance. Recall, though, that to correctly differentiate things, one must note both similarities and differences, and explain the consequences of the differences. The regulators' Buyer's Guide falls short on both scores. Consequently, in life insurance selling, such proclaimed distinctions, although being false and/or distinctions without differences prevail.

The primary advantages of cash-value policies, such as whole life, arise from their unique tax privileges. This fact is made plainly apparent by a straightforward comparison between whole life and BTID where the side-fund is not taxed (Exhibit C, next page). This comparison shows that Whole life, with its typical sales costs of approximately 130% of the first year's premium provides smaller cash-value than the BTID alternative. Without its tax privileges, despite having mortality rates and investment returns comparable with the BTID alternative, this illustrated whole life policy never provides greater cash-values than the side-fund. At the very least, these facts raise questions about all of the alleged whole life advantages and term deficiencies agents endlessly repeat. More importantly though, addressing these facts have and would seem to require market-altering consequences.

Tax privileges are free inputs. In competitive markets with informed buyers, firms can not charge for a free, non-proprietary input. Recall that consumers do not pay thousands of dollars to have an IRA or SEP established. Similarly, they are unlikely to pay such for whole life policies when the product masquerade has ended. Responding effectively to these facts – facts the life industry has long refused to face - is the crux of the industry dilemma because current life industry marketing practices, compensation practices, and recruiting practices cannot be sustainable in an environment of good disclosure. Good disclosure requires enormous change.

Final Thoughts

Promising to treat others as you yourself like to be treated requires the life insurance industry to provide appropriate cost disclosure. After all, if there is any product that you contend people buy without understanding its costs, please in the future have them buy from me! As we know, promises are easy to verbalize, yet routinely require insightful understanding, dedicated commitment, and real work to fulfill. Such work can begin with the life industry, once and for all, clearing-up the confusion regarding the difference between a cash-value policy's premiums and its annual costs.

Peter Drucker says that consumerism is marketing's badge of shame. Yet, only by reconciling its age-old dilemmas can the life industry trade-in its IMSA badge. Doing so though will provide great benefits. For example, it ought to also enable the industry to move beyond its age-old fears of losing its tax privileges. Recall that during the last two decades while many within the industry have "fought" to retain life insurance's tax privileges by, among other things, denying its policy's investment character. Yet, during this period, Congress has established and actively promoted too many tax-advantaged savings/investment programs to mention. Consequently, one is left only to wonder what the life industry could achieve by so wholeheartedly embracing good disclosure that legislators and consumers would finally recognize life policies' pre-eminent qualifications to be the leading after-tax, long-term savings and security vehicle for families.

Exhibit C

\$300,000 Whole Life policy compared with Term Insurance
with differences in premiums invested at 8.0% (0% tax bracket)
For Male Age 40, Premium \$5,592

Non-Guaranteed Dividends Used to Purchase Paid-Up Additions

	1	2	3	4	5	6	7	8	9
	Annual	Term		Difference	Permanent Policy		ROR on	Amount	Perm'n't
	Prem.	Policy	Annual	Comp'nd'd	Cash Surr. Values		Col 3 to	of Term	Policy
<u>Year</u>	<u>Outlay</u>	<u>Payment</u>	<u>Dif'r'nce</u>	<u>at A/T Rate</u>	<u>Total*</u>	<u>Guar.</u>	<u>Col 5*+</u>	<u>P'rchas'd</u>	<u>Insurance*</u>
1	5,592	292	5,300	5,724	0	0		294,276	300,000
2	5,592	309	5,283	11,887	4,421	4,176		288,950	300,837
3	5,592	335	5,257	18,516	9,317	8,475		284,258	302,774
4	5,592	354	5,238	25,654	14,711	12,888		280,137	305,791
5	5,592	373	5,219	33,343	20,642	17,427		276,518	309,861
6	5,592	392	5,200	41,627	27,140	22,083		273,353	314,980
7	5,592	410	5,182	50,554	34,255	26,868		270,582	321,136
8	5,592	432	5,160	60,171	42,022	31,782		268,140	328,311
9	5,592	456	5,136	70,532	50,492	36,828		265,976	336,508
10	5,592	482	5,110	81,693	59,732	42,006	2.46	264,089	345,732
11	5,592	509	5,083	93,718	69,801	47,319		262,427	356,145
12	5,592	540	5,052	106,671	80,657	52,758		260,717	367,388
13	5,592	576	5,016	120,622	92,347	58,314		258,910	379,532
14	5,592	616	4,976	135,646	104,884	63,981		256,870	392,516
15	5,592	660	4,932	151,825	118,328	69,753		254,558	406,383
16	5,592	707	4,885	169,246	132,727	75,624		251,893	421,139
17	5,592	762	4,830	188,003	148,147	81,600		248,796	436,799
18	5,592	828	4,764	208,188	164,636	87,684		245,150	453,338
19	5,592	912	4,680	229,897	182,254	93,885		240,843	470,740
20	5,592	1,015	4,577	253,232	201,058	100,200	6.08	235,769	489,001
@60	5,592	1,015	4,577	253,232	201,058	100,200	6.08	235,769	489,001
@65	5,592	1,801	3,791	398,412	316,232	130,095	6.53	210,269	608,681
@76	5,592	0	5,592	989,965	744,400	194,112	6.84	0	1,033,210

- Notes
- 1 Term outlays are based on new issue Term to Age 75 - Increasing Premiums.
 - 2 Term Policy Death Benefit does not include values shown in column 4.
 - 3 Amounts in Col. 8 are for illustrative purposes only. Amounts below company minimums will not be issued. Changes in the amounts in column 8 are subject to Company practice.
 - 4 The Term outlay might not ever exceed the Permanent Whole Life's premium.
 - 5 Rate of Return needed before tax, assuming a tax bracket of 0% (chosen for illustrative purposes).
 - 6 The Whole Life policy's dividend interest rate in 2001 is 8.8%

*Non-guaranteed illustrated values & benefits include dividends. Dividends assume no loan; loans may reduce dividends. Illustrated dividends reflect current (2001 scale) claim, expense and investment experience, and are not estimates or guarantees of future results. Dividends actually paid may be larger or smaller than those illustrated. This illustration does not recognize that, because of interest, a dollar in the future has less value than a dollar today. 8% loan provision.
Submitted: Agent XY on 4/10/01