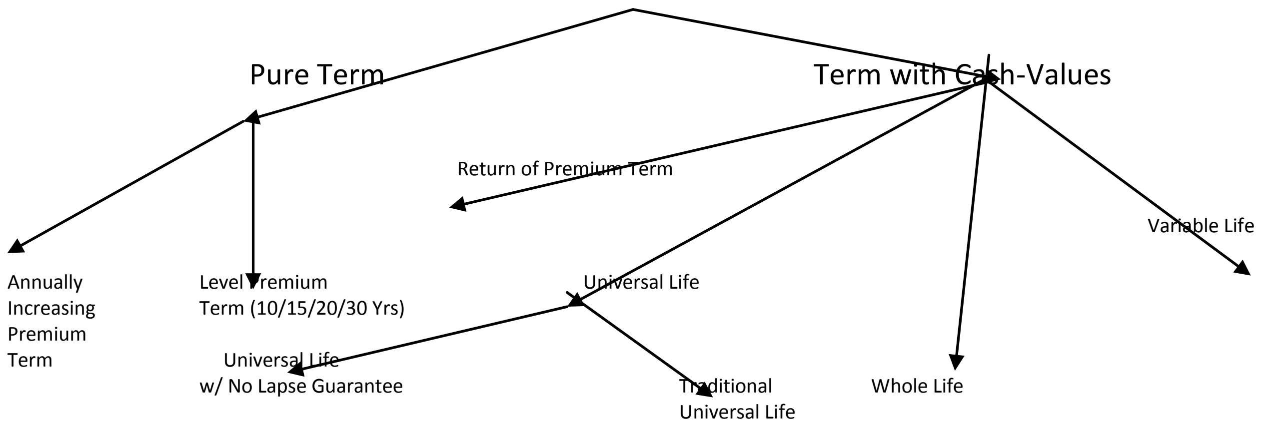
Breadwinners' Proposed Draft of a New Life Insurance Buyer's Guide

The life insurance industry needs a new Buyer's Guide for Consumers. (It has needed one for many, many years, but that's a different story.) The draft below is presented to facilitate and encourage work on this important project. Please review and submit your comments. Although state insurance commissioners' actions and inactions in the life insurance marketplace have by and large not only been worthless but harmful, there are many good, smart, conscientious, and hard-working individuals in state insurance departments who, with committed grass-roots support, might now be able to bring about effective regulations. A new Buyer's Guide ought to be one of their first accomplishments. Again, please review and submit your suggestions.

If You Need or Have Life Insurance, Here Is Information You Ought To Know

1. All life insurance is comprised of term insurance. There are pure term policies and term policies with cash-value, which are also known as whole life, universal life, variable life, etc. (See diagram below.) Each year every policy bears costs associated with death claims, which are called ***mortality charges*** or ***cost of insurance charges.*** Given that the risks of dying increase as one ages, so necessarily do the annual mortality costs of coverage. (See Paragraph 7 and Product Descriptions on Level Payment Term and Universal Life with Lapse Protection for explanations of those apparent anomalies.) That all policies are comprised of term insurance and that the annual costs per amount of coverage increase with one's age are two vital facts to understand and remember when evaluating any policy.

All Life Insurance is comprised of Term



2. Finding a good policy entails finding one that: a) provides the amount of insurance that you need for the duration that you want protection at an attractive costs, b) is set-up with proper beneficiary and ownership arrangements, c) is supported with the level of agent

advice and service desired, and d) if a cash-value product provides an 1) attractive rate or return on the investment component and 2) constitutes a suitable product for you given your objectives and constraints. Obviously, the relative importance of each of these objectives depends upon personal factors.

3. For families, the primary purpose of life insurance is to provide a source of income for one's family if one were to die prematurely and hence one's future income be eliminated. (Business and estate planning uses of life insurance are briefly discussed in Paragraph XY.) Consequently, the first step in thinking about life insurance, just as in thinking about one's needs for any other product, is to understand one's needs, which typically begins with assessing: 1) the amount needed, 2) the duration of the need, and 3) many other personal factors. (See Section on Assessing Needs for more details.)

4. Although policies are marketed with generic labels (***Level Payment Term, Whole Life, Universal Life, Variable Life, Annually Renewable Term, etc***.) and many fancy names, they can all be classified, broadly, according to five main characteristics.
    a. The guarantees or lack thereof with respect to premiums, death benefits, and possible cash-values;
    b. The pattern of annual premiums: Level or Increasing; Mandatory or Optional;
    c. The duration or renewability of coverage, i.e., 20 Years, To Age 70, Permanent;
    d. For policies with cash-value, how it is invested and other related details;
    e. The insurer's operating practices: mutual vs. stock, participating vs. guaranteed, underwriting standards, management of insurance pools, etc. This fifth characteristic involves a number of issues beyond the scope of this Guide, and which will be addressed in the forthcoming Insurers' Operating Practices article.

5. <u>Finding a good policy requires more than simply finding a good insurer</u>. Insurers market many different products, and there normally are significant differences in the value provided by an insurer's different policies. Two similar policies may entail very different costs because of differences in agent compensation paid by the insurer or pricing approach (for example, lapse supported pricing). An insurer may provide attractive term policies but not so attractive cash-value policies. An insurer may be a financially-strong company, but that does not necessarily mean it provides policies with competitive value. Because of such, there can be great value, especially with respect to cash-value policies, in working with a knowledgeable and trustworthy agent.

6. Policy Costs. **For a pure term policy, the consumer's annual cost is the policy's premium. For cash-value policies, however, a policy's annual costs must be calculated. (See Section on Cost Calculations.)** In evaluating a policy's costs, it is imperative to evaluate such costs over the planned duration for which coverage is desired. For example, a 10 Year Level Premium Term policy may seem to be very attractive unless one definitely wants coverage for at least 20 years or possibly longer. Much additional information on policy costs can be obtained from a good agent. Very briefly though, every policy's annual cost include charges for claims (death benefits paid), sales costs, administrative costs, taxes, investment

management, and profits. Primary factors in determining annual mortality costs are the insured's age, gender, health at the time the policy was issued, the length of time the policy has been in force, and the insurer's operating and pricing practices. Insurers evaluate applicants' health and risk profile during the underwriting process in an effort to assign each policyholder to the appropriate health/risk class out of the dozen or so risk classes most insurers have.

7. Level premium term policies and cash-value policies can have level premiums <u>not because</u> the insurer bears level costs in all years, but because parts of the premiums in the early years build reserves for the insurer. While from the policyholder's perspective, level premium term policies can be said to have level annual costs, this is only because the insurer uses reserves built in the early years to subsidize the inevitably higher mortality costs in the later years. In cash-value policies, the insured has access to at least a portion of the insurer's reserves, that's what cash-values are. The insurer's reserves are also used to reduce the ***amount-at- risk***, in other words, cash-value policies can be understood as being comprised of the combination of a declining amount of term insurance and an increasing cash-value or savings side-fund. **<u>The primary financial advantages of cash-value policies are not that they eliminate the increasing costs of coverage (there is no way to avoid such), but rather arise from their tax privileges</u>**. (For a further explanation see, Paragraph 9 and Section: "When does Cash-Value Life Insurance Make Sense").

8. **Beware of misrepresentations by agents** and your own possible misconceptions (perhaps largely attributable to the former's misrepresentations) **regarding the costs of cash-value policies**. Remember that the life insurance marketplace has long been characterized by inadequate policy disclosure, misleading sales presentations full of half-truths, innuendos, fanciful myths, and outright fraud. In particular, cash-value policies with their savings/investment component have been challenging for consumers to evaluate because of the life insurance industry's inadequate disclosure practices. (Until the industry adopts good disclosure practices, it unfortunately seems necessary to warn consumers. While some might assert that the principle of caveat emptor should be known by all, insurance agents and insurers have done much to disarm consumer vigilance, and hence to fail to warn is to fail to serve and protect – a mistake regulations should not repeat.)

9. **<u>The primary financial advantages of cash-value policies arise from their tax privileges</u>.** A policy's cash-values which arise from premiums larger than the policy's annual costs in its early years being invested. Cash-values grow on a tax-deferred basis while the insured is alive and are paid free of income taxes as part of the tax-free death benefit. (There are exceptions to every rule, but generally death benefits are virtually 100% tax-free for consumers.) If a policy is surrendered for its cash-value, any gain – the difference between the cash-value and the cumulative premiums paid – is taxed at ordinary income rates. The fact that the total of the premiums paid is deductible, including the portion of the premiums used for the expenses of coverage means that the policyholder is able to recover these expenses from total investment earnings before paying taxes on any remaining

investment earnings. That's a tax-advantage. Another tax-advantage of cash-value policies is that one can use the untaxed earnings/growth on the policy's cash-values to pay for or help pay for the on-going costs of coverage. That's a second tax-advantage. The annual out-of-pocket costs for a term policy can become comparatively large and possibly prohibitive because pure term policies do not have the dual effects of: 1) untaxed earnings on cash-values being available to pay for such annual costs in the later years and 2) cash-values reducing the policy's ***amount at-risk***. A third tax-advantage of cash-value policies arises from their borrowing privileges, that is, that is, amounts borrowed from policies are untaxed provided that coverage remains in-force until death. Policy loans incur interest charges, but substantially almost all of the interest can be credited to the policy's cash-value by the insurer. For additional information about such, for example the risks of a forced surrender when a policy has been excessively borrowed against.

10. **Additional advantages** of cash-value policies are their **A)** potential permanence, **B)** potentially lower future mortality costs, and **C)** potentially increasing death benefit. **A)** Pure term policies eventually expire or cannot be renewed. In contrast, cash-value policies can be automatically maintained, subject to paying necessary premiums, until one's eventual death. However, pure term policies that can be ***converted***, have essentially the same potential permanence as cash-value policies. **B)** Cash-value policies can also have comparatively lower future mortality charges because of their policyholders' greater ***persistency.*** That is, a comparative greater percentage of cash-value policyholders than term policyholders keep their policies 20, 30 years, or longer. Therefore, for example, in the 31st year, an insurer on its cash-value block of business can have a comparatively healthier pool of insureds over which it can spread the 31st year's death claims than it might have on its pure term block of business. (See also Glossary for ***adverse selection***)**.** **C)** Some cash-value policies also provide dividends and/or alternative riders that can be used to increase one's coverage without an additional medical examination. Such opportunities for increased coverage can obviously be very valuable if one's no longer healthy or not as healthy as his/her peers.

11. **Policy illustrations do not represent an insurer's best estimate of the future, and they should not be used to compare policies until one understands how each policy works, and the assumptions imbedded in the illustration**. Similarly, do not use interest-adjusted indexes calculated from policies to compare policies. (Obviously, a sentence that could be eliminated once the industry discontinues its use of the inherently defective interest-adjusted indices. Please be sure to vote in Poll on this topic.) In comparing policies, be sure to understand A) what is guaranteed, b) not guaranteed, and C) how non-guaranteed values change, can possibly, or are likely to, change, or how the insurer determines such.
12. XXXX
13. Section on Business Uses of Life Insurance
14. Section on Estate Planning Using of Life Insurance

Glossary (next page)

Annually Renewable Term A policy on which the annual premium increases each year.

Level Premium Term for 10, 15, 20, or 30 Years A policy which has a level premium over the specified duration. Typically, the insurer guarantees that the premium will not change. In essence, such policies can be thought of as the insurer charging an average of the premiums of an annually increasing premium policy over the particular duration. These policies can have attractive costs because of ***lapse-supported pricing***.

Refund of Premium Term A policy which promises after a specified duration, generally 20 or 30 years, to refund all the premiums paid. Obviously, these policies have larger premiums than Level Premium Term because the insurer not only pays claims throughout the duration, but also makes a "refund" at the end. To obtain the refund, the policy must have been kept in-force until the end of the specified period. Such policies can be somewhat similar to cash-value policies, except that the policyholder does not have access to the cash-value until a specified duration. Refund of Premium Term can be both a complicated product for most consumers to properly evaluate and a comparatively very expensive one if lapsed.

Universal Life A cash-value policy which does not have a mandatory premium. This policy stays in-force as long as there is cash-value, which grow, like any cash-value policies, based on premium payments, investment earnings/interest the insurer credits to the policy, and expense charges the insurer deducts.

Whole Life A cash-value policy with a guaranteed level premium for life and guaranteed cash-values. Whole life policies can be issued on a strictly guaranteed basis, or on a participating basis, whereby the policy's death benefit and cash- values can increase above the guaranteed values because the insurer's favorable financial experience/performance is shared with policyholders via ***dividends.***

Variable Life A cash-value policy where the policyholder specifies where the cash-values are invested among the various investment/mutual funds the insurer offers.

Universal Life with Secondary Guarantees or No-Lapse Protection A Universal Life policy which contains an extra guarantee that the policy will not lapse even if the cash-value is zero. Consequently, these policies can have 1) lower premiums than ***Whole Life*** because they do not provide as significant guaranteed cash-values, but they thereby also 2) impose greater costs upon policyholders who surrender.

At-Risk Amount This is the actual amount of insurance in a cash-value policy. It is the difference between the current death benefit and the insurer's reserves. For all practical purposes, the available cash-value can be used as a proxy for the insurer's reserves on conventional cash-value policies. For some UL policies, those with Secondary Guarantees or No-Lapse-Guarantee and which have "shrinking or disappearing cash-values, " more detailed actuarial information than the policy's cash-value is needed to calculate the policy's at-risk amounts.

Convertibility (Convertible Policies) Term policies which can be converted to cash-value policies without proof of insurability at time of conversion are convertible. This option or privilege is generally limited to a number of years (i.e., 10 or 20 years) or before a certain age (say, 60 or 65). The value of this option can be seen by considering an individual with a term policy that would expire at age 70, but who at age 64 learns that he has a serious illness, although unlikely to die in the next few years. Converting the policy allows him to maintain insurance when he otherwise be unlikely to obtain as cost-effective coverage. It is always important to evaluate one's future insurance needs and health before allowing a conversion privilege to expire.

Dividends Insurers that provide participating whole life policies pay dividends when their financial performance is better than the minimum performance required to meet their policy guarantees. Dividends are best thought of as an insurer's distribution of its annual profits, and arise from three components: 1) investment returns being better than the minimum returns need, 2) mortality claims being less than the maximum claims allowed, and 3) similarly administrative and other costs being less than the maximums established in the policies guarantees. For tax purposes, dividends are not subject to tax if left in the policy; if removed from the policy they are only taxable to the extent that they exceed total premiums paid.

General Portfolio Policies Life insurer's assets can be held under the company's direct control or in a ***separate account***. Assets held under the company's control are said to be a general portfolio product. Insurers can combine all assets backing all of their policies in one investment fund, or they can segregate assets by 1) year premium was received, or by 2) policy, etc. General portfolio products have minimum guaranteed investment returns, and changes in the market value of the portfolio are not reflected in the policyholder's cash-values being marked-to-market on a daily basis.

Health Classes Insurers evaluate applicants' health during the underwriting of the policy and assign the insured to a particular health class, in which the insured remains (generally*****) as long as she/he maintains the policy. Most insurers have several classes of health; typically labeled from best to preferred to standard to highly-rated to uninsurable. *Occasionally, insurers issue a policy on which they agree to re-consider the insured's health in a few years, and if it has improved, the insurer will upgrade the policy's health class; otherwise the health class remains unchanged as a policy's health class can never be downgraded.

Lapse Supported Pricing An operating practice whereby insurers "overcharge" in the early years of a policy and then apply those overcharges (to subsidize the costs) in later years when there are comparative fewer policyholders due to the fact that a certain percentage (generally 3-7%) discontinue or lapse their policies annually. This practice is widely used in ***Level Premium Term*** and ***Universal Life with Secondary Guarantees***.

Paid-Up Additions These are insurance amounts (small increases in death benefits) arising from dividends being left in the policy. They are called "Paid-Up" because no other premiums are required to support the small increase in death benefit, that is, they are basically a single premium. These "Additions" can always be surrendered, just like their original policy, for their cash-value.

Participating Policies When actuaries determine guaranteed premiums, they must use very conservative assumptions for claims, expenses, and investment earnings, etc. Given that actual performance is (virtually* never as bad as these assumptions, insurers realize profits. Participating policies are ones where the insurer uses such profits to pay dividends to policyholders; that is, policyholders participate in the insurer's favorable performance.

Persistency measures the percentage of policyholders who keep their policies in-force from one year to the next. A lapse rate, in contrast, is the percentage of policyholders who surrender or allow their policy to lapse. Policyholder persistency is important because of its impact upon an insurer's future performance.

Separate Account Policies These are variable products where policyholders retain some control with respect to the type of funds the assets backing his/her policy are invested. Most separate accounts are comprised of many different "mutual fund" choices, where the returns are not guaranteed and the values of the assets are marked-to-market daily.