Consumer Federation of America

EARLY LIFE INSURANCE TERMINATIONS AND WASTED CONSUMER EXPENDITURES

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Executive Summary

In 1993, there were more than 100 million cash-value life insurance policies in force with death benefits of $4.0 trillion. In that year, $65 billion of the $94 billion in premium receipts to U.S. life insurance companies represented consumer payments on cash-value policies. But a significant portion of these premium payments were wasted because of early policy terminations.

CFA estimates that these wasted expenditures exceed $6 billion a year. Those cash-value life insurance purchasers who terminate, in the first few years after policy issue, lose a sum that typically exceeds $1000 and frequently reaches several thousand dollars.

To reduce this wasted expenditure significantly, CFA recommends three reforms.

- Require companies and their agents to make upfront written and oral disclosures that a cash-value policy must be held for at least 15 to 20 years to provide good value.
- To discourage churning, legally require companies to find that any replacement of an existing cash-value policy must be suitable to the policyholder.
- Prohibit heavily front-loaded commissions paid to agents and require companies to spread out this agent compensation more evenly throughout the term of the policy.

It is essential that consumers plan to hold cash-value life insurance policies for at least 15 to 20 years to receive reasonable value. They should consider purchasing these policies from companies with low termination rates.

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An Introduction to Cash-Value Life Insurance

There are two general types of insurance policies. Term life policies provide only a death benefit. Each year that policyholders pay premiums, they qualify for this death benefit. When they stop making these payments, their term insurance lapses.

Cash-value policies provide both death protection and a savings/investment component. A portion of premiums paid provide a death benefit as long as payments are made. The remaining portion of the premiums is invested by the insurer for the policyholder's later use. For those not wishing to hold their policies until death, this cash-value can be received as monthly payments or in one lump sum upon termination of the policy. Or it can serve as the collateral for a loan whose rates can be relatively low.

There are three principal types of cash-value policies. Whole life insurance guarantees that you can continue coverage as long as you live without risk of an increase in premiums. The most common form of this insurance calls for premium payments of the same dollar amounts each year for life. Universal life insurance provides policyholders with the ability to vary their premium payments from year to year. To retain death protection, however, premium payments cannot fall below a certain level. A third type of cash-value policy, which is growing in popularity, is variable life insurance, whose cash value can be invested at the policy holder's direction in separate accounts similar to mutual funds.

In 1993, there were 113.5 million cash-value policies held by individuals. (This number does not include 4.5 million group whole life policies and a larger number of low-value industrial whole life policies.) These policies represented total death benefits of nearly $4 trillion.

In 1992, 78 percent of all households had some form of life insurance. The average coverage for individual policies was $100,000; the average coverage for group life was $64,900; and the average total coverage per household was $121,800. The apparent discrepancy between these numbers is explained by the fact that many households have group life insurance at work but no individual coverage.

Nearly all individual (or ordinary) life insurance policies, as opposed to group life insurance policies, are sold by life insurance agents or brokers. In 1993, there were 662,000 insurance agents, brokers, and related service personnel in the U.S. While they usually specialize in one type of insurance, many agents and brokers also sell several types -- life, health, and property/casualty, individual and institutional. But only

138,000 agents and brokers belong to the National Association of Life Underwriters, the major trade association of life insurance agents.

The Problem of Early Terminations

Largely because of heavily front-loaded agent commissions, terminating a cash-value policy within the first ten years can prove very costly to consumers. Terminating such a policy even between its tenth and fifteenth years can result in low returns. Cash-value life insurance policies perform best when kept for more than 20 years.

Most life insurance companies pay agents commissions that range between 55 and 100 percent of first year premiums. These companies, however, reduce commissions substantially -- almost always, to well below 10 percent of annual premiums -- in succeeding years that premiums are paid. From years two to nine, for example, they may pay agents five to eight percent, then in years ten and beyond, drop the commission to two percent or less.

This commission structure provides agents with a strong financial incentive to sell new policies instead of encouraging consumers to hold onto existing policies. Many agents, as a matter of principle, avoid disturbing existing cash-value policies. But some agents look for opportunities to persuade policyholders to terminate existing policies and purchase new ones. A recent article in the Wall Street Journal (1-3-95) reported evidence of agent "churning" that it described as the "most extensive ethical violation."

Frequently, terminating a cash-value policy can prove extremely costly. Consumer A who purchases a typical cash-value policy and holds it for 20 years could pay around $20,000. Consumer B who receives the same death protection and cash-values as Consumers A, but terminates and repurchases three times at five-year intervals during this 20-year period, could pay around $25,000. More frequent "churning" can of course increase the difference in consumer cost even more significantly.

The good news for consumers is that, in the past decade, the voluntary termination rate on all life insurance policies has been declining -- from 12.3 percent in 1985 to 7.6 percent in 1993, according to the American Council on Life Insurance. The bad news is that about half of the cash-value policies terminated in 1993 have been held less than ten years.

The Consumer Cost of Early Terminations

The losses consumers incur when they terminate cash-value life insurance policies prematurely can be generalized as follows:

- Those who terminate in the first two policy years lose their entire investment.
- Those who terminate after five years receive no interest on their investment and lose about 10 percent of their principal.
- Those who terminate after ten years receive a low return on their investment, perhaps 2 to 3 percent.
- Those who terminate after 15 years receive a decent return on their investment, perhaps 4 to 5 percent when current interest crediting rates are around 7 percent.
- Those who keep their policies 20 years receive a good return on their investment.

By "investment" in the discussion above we mean the excess of the cash-value policy premiums paid over the annual cost of term life protection. A typical, $100,000 cash-value policy might have a premium of $1000, whereas term life would cost perhaps $150 in the first year with increases of 8 to 10 percent a year thereafter.

There are at least two ways to calculate aggregate wasted consumer expenditures on cash-value life insurance premiums. One method is to assume that all who terminated these policies in the first 15-20 years had bought term life insurance instead.

A second method is to calculate the present value of future losses over a 20-year period for cash-value policies sold in 1994. The losses for each policy year are taken as the differences between the account values and the surrender values for a typical universal life policy. We have used this method because it is the more conservative.

This second method produces estimated consumer losses of more than $6 billion annually. (The actual losses on policies surrendered in 1994 but purchased in the prior 20 years would be somewhat lower because of lower dollar premium volumes in those years.) The precise calculation is as follows:

1. Ordinary life insurance premium receipts, 1992, first year only, equal $11,140,000,000 (excluding single premiums). Source: '93 Life Insurance Fact Book, p. 36.

2. Ordinary life includes term, whole life, variable life, and universal life (including ISWL).
   Estimated percentage of total premiums (LIMRA for 1991):

Term	13%
Other	87%

   Assume term is 15 percent; cash value first premiums for 1992: 0.85 x $11.14 billion = $9.5 billion

3. Growth rate in premiums, 1992-94: Assume no growth, thus estimated first year premiums, excluding term and single premiums for 1994 equals $9.5 billion.

4. Policy value of surrender charges expected to be imposed on 1994 cash-value policies sold (excluding single premium): 0.115* x $9.5 billion x 5.8** = $6.3 billion.

   *From Appendix A, last line.
   **From Appendix A, sum of column (C); present value of future premiums of $1.

<u>Life Insurance Companies with Low Termination Rates</u>

In 1992, the median termination rate on non-group life insurance policies was 9.8 percent, with a range of 1.6% (USAA Life Insurance) to 20.0% (United Insurance Company of America). There are many factors influencing termination rates, including the company's product mix, customer base, and methods of marketing. But the willingness of a company's agents to churn is also important.

Such willingness is influenced mainly by the personal character of the agents and by the policies and practices of the companies and independent sales agencies regarding the churning. One widespread industry practice that tempts agents to churn is high up-front commissions, which sometimes are more than 100% of policy premium. This high rate contrasts with renewal commission rates that are usually less than 8% and often as low as 2%. .

For the three-year period, 1991-93, of the 150 largest life insurers, those companies with the lowest average annual termination rates were the following:

Pacific Mutual Life Insurance Company	2.1*
USAA Life Insurance Company	2.3
Teachers Insurance & Annuity Association	3.7
Aid Association for Lutherans	4.0
Lutheran Brotherhood	4.0
Savings Bank Life Insurance of MA	4.3
Century Life of America	4.4
Northwestern Mutual	4.9

*Rates exclude universal life subsidiaries of major companies with relatively high lapse ratios. Source: Best's Review, Life and Health Edition, December 1994, 16.

Needed Reforms

The implementation of three types of reforms would significantly reduce termination rates on cash-value policies and curtail churning:

First, there needs to be effective consumer disclosures of the costs of early termination of cash-value policies. Agents (or company salespersons) should be required to disclose verbally and in writing, before the policy is purchased, that the policy must be held for at least fifteen years to provide adequate value and that early termination could prove very costly. A standard hypothetical chart comparing the cost of a policy terminated after five and after fifteen years would illustrate the significant financial cost of early termination.

In January 1995, the United Kingdom required life insurance companies to disclose agents' commissions. This requirement was based on an analysis, commissioned by regulators, that suggested such disclosure would save consumers $1.56 billion per year. Early indications are that the requirement is serving the consumer interest: Insurers are moving to level commissions, simplying products, and reducing costs.

Second, agents and companies should be held accountable for the irresponsible sales practice of churning. Agents should be required to give "prudent advice" when they review existing cash-value policies. Companies should be held legally responsible for unjutified replacements of such policies. The way to accomplish this is for states to adopt suitability requirements for replacements to existing policies.

Strengthening such regulations is especially important because of the growing popularity of variable life insurance policies, which shift investment risk to the policyholder. The availability of variable life insurance policies pose a temptation to agents to use best-case illustrations to persuade policyholders to shift from traditional whole life and universal life policies to variable ones.

Third, agent compensation should be restructured. Heavy front-loaded commissions paid to agents should be prohibited. Companies should be required to spread out this compensation, limiting commissions and other acquisition charges on first-year premiums to 50 percent. One way to do this is to require a first-year surrender value of at least 50% of the first year's premium.

The 50% maximum first-year commission, however, should represent only a limit, not an ideal. Paying agents agents a schedule such as 30% of premium the first year, 12% the next nine years, and 3% thereafter would compensate agents adequately while providing better incentives to discourage early policyholder terminations. Such a restructuring would also increase their incentive to persuade policyholders to maintain cash-value policies for many years, thus increasing the value of these policies to these consumers.

Advice to Consumers

Cash-value policies are not appropriate for many households. But if you decide to purchase one, to avoid losing money on an early termination, plan to hold it for at least 15 to 20 years.

Do not let an agent or company persuade you to replace a policy unless you have independently established that such a termination and repurchase makes good financial sense. Since that is virtually impossible for consumers to do this on their own, CFA offers a service to evaluate one's existing policy to determine if it should be replaced. Call 202-387-6121 for information about this service.

Consider purchasing cash-value policies from companies with low termination rates. These companies are more likely to employ agents (or salespersons) who will not encourage replacement but will urge you to maintain your policy for many years.

Appendix A

MALE NONSMOKER AGE 35
Universal Life, Option1, $100,000 Level Death Benefit
$1,000 Annual Premium - 6.25% Current Interest Rate

	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
Policy Year	Mortality Rate per 1,000	Lapse Rate per 100	EOY Discount Factor (Lapse, Int., Mortality)	Present Value of Death Benefit MOY	Policy Account Value	Policy Surrender Value	Present Value of Surrenders	Pres. Val. of surrs if Col. (e)
0			1.00000					
1	0.38	16.1	0.78935	36.87	799	-	0.00	121.03
2	0.46	9.8	0.66980	35.23	1,640	-	0.00	119.35
3	0.59	7.0	0.58593	38.34	2,527	798	35.19	111.45
4	0.68	6.8	0.51361	38.65	3,461	1,796	67.30	129.70
5	0.77	6.6	0.45115	38.37	4,422	2,844	90.67	140.97
6	0.83	6.6	0.39626	38.33	5,445	3,922	109.82	152.47
7	0.93	6.6	0.34801	35.75	6,517	5,068	124.63	160.26
8	1.05	6.5	0.30593	35.45	7,660	6,287	133.71	162.91
9	1.18	6.5	0.26890	35.02	8,879	7,583	141.75	165.98
10	1.32	6.4	0.23657	34.43	10,177	8,961	144.95	164.62
11	1.47	6.3	0.20832	33.74	11,558	10,426	146.03	161.89
12	1.63	6.2	0.18361	32.94	13,026	11,982	145.42	158.09
13	1.82	6.1	0.16197	32.42	14,584	13,635	143.47	153.46
14	2.04	6.0	0.14301	32.06	16,237	15,389	140.47	148.21
15	2.26	5.9	0.12637	31.35	17,988	17,249	136.87	142.52
16	2.59	5.9	0.11163	31.75	19,861	19,280	134.94	139.00
17	2.94	5.8	0.09868	31.84	21,839	21,306	129.45	132.68
18	3.30	5.7	0.08729	31.59	23,926	23,512	124.05	126.24
19	3.74	5.6	0.07726	31.67	26,127	25,843	118.45	119.75
20	4.23	5.5	0.06843	31.71	28,443	28,304	1980.19	1982.99
			5.83205	685.51			4047.16	4693.56

Notes: Col (a) : Industry average rates estimated for 1994 by Tillinghast
Col (b): Bragg 1993 lapse rates for whole life; lapses at end of year (EOY)
Col (c): (1- .001*(a))(1-.01*(b))(Col(1),prior year)/1.0625)
Col (d): 100,000 (Col (a) / 1,000)*((1 / 1.0625) ^ .5)*(Col(1), prior year); deaths in middle of year (MOY)
Cols (e), (f): Filtcraft 1994, Aetna UL, some values interpolated
Col (g): Col (f) * Col (c), prior year * Col (b) * (1 - (a)/1000)/1.0625
Col (h): Col (e) * Col (c), prior year * Col (b) * (1 - (a)/1000)/1.0625

	Surrender Value	Account Value
PV Premiums	5832	5832
PV Deaths	-686	-686
PV Surrenders/AV's	-4047	-4694
PV Retentions	1099	452

PV of Surrender Charges as % of PV Premiums = (4694 - 4047)/5832 = 11.1%

Note: A separate calculation for issue age 45 gave 12.0% as the ratio of the present value of surrender charges to present value of premiums. Use 11.5%.