The Crisis in Life Insurance

There's a crisis? Does this mean companies are failing? Are they paying death benefits? I hear there have been some lawsuits involving different life insurance schemes, like non-recourse premium finance and STOLI (stranger-owned life insurance where people sell their personal death benefit capacity to third party investors), is that what you mean?

The crisis lies in the drawer you put your life insurance policy in immediately upon purchasing it. This is where most policies land, in a file drawer, in the basement in a box, in a safe deposit box, at the office in your personal files never to be touched again. For most people they believe that as long as they pay their premium they will have their life insurance. *This is most certainly not the case!*

Let's go back in time to gain some perspective of what has happened in the industry that you need to be aware of if you are going to save your life insurance, which in most cases represents for your family one of their largest assets. What I have discovered is that this very valuable asset is the least managed of any asset or property one owns.

Before the mid to late 70's the only insurance that was available in the market was whole life insurance and different forms of whole life (whole life, endowment whole life, retirement income whole life, etc.). Whole life insurance is what most people understand to be all permanent life insurance. In whole life insurance if you pay your premium, yes, you are guaranteed to receive your death benefit.

I will simplify my explanation of whole life for your benefit with the hope that you come to a better understanding so that as we move along our timeline you will have clarity and a basis for comparison. Whole life insurance, as with all life insurance, basically has 3 components:

- Expenses
- Mortality costs
- Cash value

When you buy a whole life policy based on your health and age the insurance company guarantees the expense factor and mortality cost factor built into the pricing of your policy. The cash value component and its corresponding growth upon continued premium payments returns a dividend which is technically a return of premium so it is a tax free payment normally reinvested back into the cash value each year. The cash value represents a portion of your premium that is invested by the insurance company after certain expenses, mortality costs, profits are taken out. The cash value return is a result of the return on the general account of the insurance company. They invest in bonds, real estate, mortgages, and long term assets to match the long term nature of the liability, which is the payment of a death benefit many years into the future. The insurance company builds in the expense factor, mortality costs, other various pricing assumptions and profit margin on a guaranteed basis. The premium calculated for your pure whole life policy is based on a reserve rate which basically means that if there are no dividends paid the cash value that is guaranteed contractually is assumed to grow at a specific regulated rate of return and the cash value will equal the death benefit at age 100.

There is a long history (100 + years) that whole life policy cash values do generate a dividend payment. Each year the Board of Directors of the insurance company declares what the dividend scale will be after they add to surplus additional reserves to pay future claims. If the expenses or mortality costs increase or decrease in any one year they are either added to or subtracted from the dividend payments. But as long as you pay your premium and you do not encumber the policy with withdrawals or loans from the cash value you are guaranteed your death benefit. Therefore, whole life with its guarantees built-in is a very good life insurance investment or asset with no surprises attached.

What happened in the mid 70's was interest rates went seemingly straight up and inflation became the reality. Money market funds were just becoming a mainstream investment and they were getting a 17%-20% return based on the current short term interest rate environment. The yield curve, for those that understand it, was inverted, short term rates were high and long term rates were lower by comparison.

The insurance industry was inundated with requests from policyholders to borrow money from their whole life policies at a 5%-6% guaranteed rate and then invested the proceeds into money market funds paying 17%-20% interest. The arbitrage was a fantastic opportunity. The other affect that became apparent to the insurance companies that needed to be changed was that whether you borrowed from your cash value or not you received the same dividend payment. Therefore it paid to extract cash values form your policies.

The industry had to do something. They did two things; first, they started to "recognize" whether a policy had a loan and if it did they would pay a lower dividend, this policy became known as "Direct Recognition" dividends; second, If the consumer wants those interest crediting rates (15%++) they would have to redesign their product offerings. This was the beginning of the product development phenomenon that continues today. The advent of performance based life insurance came to be reality.

What is performance based life insurance? Let me explain. The insurance companies and their actuaries figured out a way to build a product that would give the consumers what they supposedly wanted, a high short interest crediting rate on their cash value. The product that was developed became known as Universal Life. It debuted in 1977 through E.F. Hutton Life Insurance Company. The large dominant mutual life companies were slow to react. Product development was not the name of the game at the time. Whole life was a very profitable product.

Universal Life was structured by unbundling the components of life insurance. The expense factor that was charged to the policy was the actual current expense ratio for that particular insurance company. The whole life product builds in the expense factor with a large margin and guarantees it but UL just charges the current expense factor. The catch? The expense factor can change in a UL policy to reflect any changes. The expense factor charged could be changed up to a certain guaranteed limit. The same goes for mortality charges. What the insurance companies did was to charge a cost of insurance (COI) on a current basis increasing it each year as the insured got older. The COI is a rate per $1,000 applied to the actual insurance or net amount at risk (NAR) in the contract each year. What is the NAR? It is the difference between the cash value and the death benefit. It is the pure insurance in the contract.

So what happened? The UL product was able to charge a lower expense factor and current lower mortality charge. The illustrations that were shown by agents assumed a current interest rate of 14% - 18%. Illustrations are flawed in many ways. They project current market conditions into the future but we all know that markets move and so do all the other parts of a life insurance policy. To continue, the premiums that were calculated to fund all the future costs assuming these high interest rates were extremely low when compared to whole life premiums. Agents were not educated at the time about how life insurance was built. Therefore, the lowest common denominator was, and still is, in many cases price. UL became the “flavor of the day” in the mid 70’s into the 80’s.

When interest rates started there slow decline, what happened to these polices? Remember there are no guarantees in UL; the premium is actually an estimate of a deposit that needs to be made based on non-guaranteed expense and mortality factors and an assumed interest rate as the illustration dictated. Remember the NAR (insurance portion being paid for) had applied to it a mortality cost factor that increased each year. If you paid a certain premium under the interest rate assumed then the insurance costs would be funded per the illustration. What happens if interest rates decline, as they did? In essence the policy was underfunded. The NAR must decline at a rate where the premium and the interest credited could pay for the increasing cost of the NAR but if the NAR does not converge quick enough (cash value and death benefit amount converge) the premium + the interest credited would not be able to support all the future costs and at some point in the future the policy would die or lapse with no value and therefore you lose your valuable life insurance. The policy lapses with no value because in years that the premium + interest was not large enough to pay the costs of the policy, namely the cost of the insurance, the cash value would be drawn upon to make up the balance due. As most policies are left unmanaged you can see that sooner rather than later the policy would have zero cash value and therefore lapse.

UL faces risks if the low interest rate environment continues much beyond 2014:

- The consumer who expects when interest rise that their crediting rates on their policies will follow this upward trend may be surprised. The insurance company balance sheets have been “beat up” and to shore up their profitability they will need to keep a bigger spread between what they credit and what they earn on their investments.
- If interest rates stay low another way for insurance companies to improve profitability will be to consider increasing the non-guaranteed cost factors inside these policies.

One solution a particular insurance company implemented which backfired as they had to eventually be rescued was as interest rates declined, in order to support higher crediting rates they had to buy more and more junk bonds. Well, we all know what happened to the junk bond business. Many agents who had replaced life insurance policies with Executive Life policies ended up doing a great disservice to their clients. Other companies were hurt by the real estate fallout during that time. Many had their ratings reduced and people were scared.

One impact on the industry due to this failure was the regulators made new investment criteria regulations. They basically had to have investment portfolios that consisted mainly of investment grade bonds and the rating game was on. This meant that margins were squeezed and profitability decreased which accelerated consolidation of companies. It also meant that in order to distribute more product to increase earnings to satisfy the public shareholder environment the insurance companies decreased renewals by 85% over a period of time. The net effect was that the industry became all about sales and the superior service that many had been known for became a thing of the past.

Being the least managed asset on anyone's balance sheet, the agent's desire to just distribute more product and their unwillingness to bring bad news to their client for fear of losing their trusted relationship, the answer seemed to inevitably be a new product.

After the UL problems started to appear and interest rates declined precipitously, the stock market started to boom. So what does the consumer want or desire now in their life insurance asset? They wanted those stock market returns!

There is no way through the traditional life insurance distribution channel for clients to really understand the impact that market and interest rate volatility have on any one particular life insurance product due to the lack of any analytic tools. The life insurance business is the only financial services area that allows you to illustrate to the public how a product works by assuming all the assumptions made inside the product never change and projects current market conditions well into the future. There are no analytic tools, like being able to back test using historical rates of return, in order to develop a probability of success for a particular product. When markets go down the monthly deductions for the cost of Insurance, which increases over time, exasperates the loss and ravages the cash value. The market has to go up so much farther and faster than anyone really anticipated. As you approach and enter into your 80's the cost of insurance charge per $1,000, within these performance based insurance products, applied to the Net Amount Risk goes up significantly each year. If the difference between the death benefit and cash value is not relatively close policies will lapse in a very short period of time. For example, I have seen a death benefit of $1,500,000 of variable life with $880,000 of cash value by age 82, but between 83 and 89 the cash value disappeared and the policy lapsed at age 90!

Let me go back the product illustration problem I have described. Technology came into the market with the advent of the computer and over time it became an illustration game not a relationship game. The old way of marketing, when whole life was the only product, was to show the consumer that the dividends projected which were going to be paid were always lower than the amount they actually paid. Technology caused a major shift in the ability to now illustrate projected dividends; in effect assuming that they would always stay the same or increase from the current level. Now remember interest rates were high for a period of time so instead of being conservative, all the companies due to technology and the "new" illustration system were able to show these high interest rates continuing into the future. The "illustration" fight was on within the industry. Everybody boasted about their balance sheet and their ability to keep increasing dividends.

Many companies had so much real estate in their portfolios that many estimated that they could support these increasing dividend scales by harvesting capital gains on real estate. Guess what happened to the real estate market back in the late 80's and interest rates. That's right; real estate went south as well as interest rates making all the illustrations flawed.

So let's look back at the last 25 yrs.

- Most life insurance sold in the last 25 yrs. has been performance based life insurance without any guarantees of either premium or death benefits!
- Technology and the illustration system were built to represent projections that were unsustainable
- Interest rates, dividend payouts, market declines have wreaked havoc on the long term viability of the products sold
- Regulations came about to make the portfolios of insurance companies much more risk averse another factor causing these projections to be too rosy
- Illustrations that showed premiums would not have to be paid after a certain period of premium payments will haunt those that do not review their property performance
- The bad news after many years of product under-performance have ill equipped the distribution system to deal with the service issues, because they do not get paid for service only sales
- The "black box" of life insurance has only gotten darker as product design has increased exponentially and the complexity has increased
- No new people coming in the business
- Agent training programs at the insurance company level are no longer in existence
- Renewals are down 85%
- The explosion of a secondary market for life insurance caused abuse in the market
- Lack of trust has emerged as an issue for the industry
- Lack of objectivity and the frustration with the complexity of the products has heighten the doubt among consumers and their advisors
- Lack of tools to analyze and remediate life insurance

These factors have contributed to a major change in the culture of the life insurance industry. It used to be that you were an agent for a particular company. They had a solid product line consisting of a few very good products. You were trained by your company. You could build a very good business with a solid renewal base around the risk products you sold your clients.

Then products began to be manufactured at an alarming rate, margins were squeezed, consolidation in the industry and with the advent of many carriers needing more capital to grow many demutualized and went public. Manufacturers came to realize in order to grow they had to distribute significantly more product through more channels to keep their earnings growing fast enough. Manufacturers have slowly separated from the distribution channel. Many of the life insurance companies have dismantled their agent forces. The compensation structure changed over time where renewals and the ability to build a recurring revenue stream became non-existent. Renewals have decreased by 85% over the last 10-15 yrs. Life insurance became a distribution game where the only thing that mattered to the industry were sales and therefore service has been destroyed. Agents had to sell, sell, and sell, to survive. This sales centric model has significantly impacted the industry distribution and consumer satisfaction.

Over the last decade many turned to the “review and replace” model of selling. 90% of products are not performing as projected but to those that relied on this review and replace model they could count on new products being developed where they were able to always show the consumer that a new and different solution was the answer even though what they had was usually a very good product. If you do a “free review” and you only get paid for new sales then the “lens” that you look through will always find a “better” product for you to switch to in order to make the sale. Since there are no tools to use to actuarially determine if the policy you have can be remediated or replaced the only exercise the agent could do was to examine different products and build a story for replacement from illustrations and a sales pitch that sounded plausible. The consumer had no way or no advocate to help them decipher the decision.

The lack of growth in properly trained sales agents has become a reality. There are no longer any training programs. There is a lack of being able to build a nice recurring revenue stream so many life insurance agents have actually have turned their backs on life insurance as a revenue stream due to the lack of objectivity and complexity in the market and have turned their practice into a wealth management model (gathering assets to manage).

There came to be some abuse in the life insurance market caused by both the insurance companies and agents. I will not go into a full explanation of the abuses but with the opening up of a secondary market with hedge funds not really knowing how to buy policies the agents figured out unique ways to take advantage of the arbitrage. To give you an example, agents would sell and finance the premiums of a large amount of life insurance where they would in some cases misrepresent the net worth, buy more than the general market would allow and plan on selling some of the insurance to pay off the loan and finance the balance of the life insurance. When the secondary market found out their mistakes they made in calculating life expectancies changes quickly happened, the economic crisis had an impact and many of these programs fell apart because you could not sell the insurance. In some cases the loan agreements were not renewed and the consumer got into a tight spot by having loans and interest due and policies that were not performing.

In conclusion, let me point out for you the following:

- 90%+ of life insurance policies are not performing as projected
- The impact of the changes that have occurred within the moving parts of performance based life insurance have left many of these polices in dire need of review
- Life insurance fails for 2 reasons:
  - Improper acquisition up front based on assumptions and projections that are bound to fail
  - Lack of management, putting the policy on "automatic"
- Life insurance is the least managed asset on the balance sheet, yet in many cases it is one of the largest single assets of the family
- The culture of life insurance has changed from one of trust and service to sell, sell, sell
- Illustrations are flawed
- There is no capability to identify price and cost competitiveness
- Many Trustees of life insurance trusts are in harms way due to their lack of understanding of their duties per the Uniform Prudent Investors Act
- There is lack of property management processes and analytic or actuarial tools to manage life insurance
- Consumers are frustrated with the lack of objectivity and complexity they face within the sales process
- There is a lack of understanding of the science of life insurance and how this kind of methodology can help remediate policies

I do believe that life insurance is a wonderful piece of property and can be a tremendous asset in the wealth transfer, financial planning and charitable arena. The reasons to own life insurance and the use of life insurance within the holistic planning environment are numerous. But, as you can see, life insurance is a complex financial instrument that merits proper management like any other asset on one's balance sheet.