Fairer Product Comparisons– Cover Article

Issue Entitled, Policy Comparison: Making the Best Selection

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POLICY COMPARISON

MAKING THE BEST SELECTION

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FEATURES

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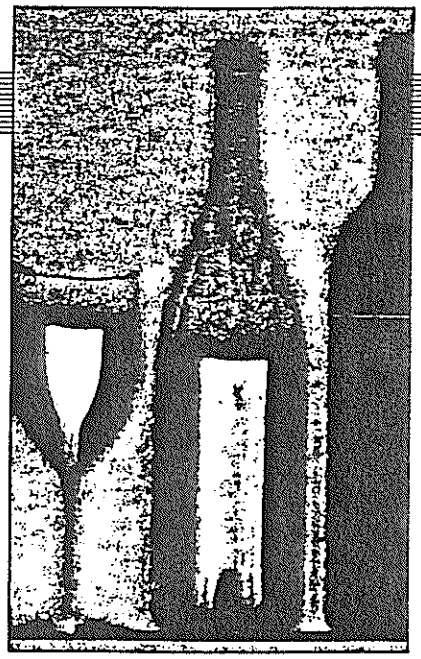
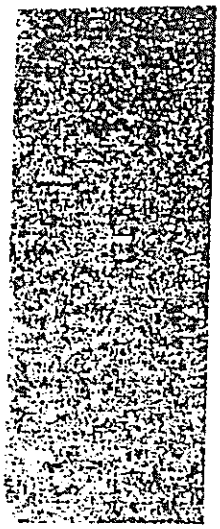


ABOUT THE COVER: An agent has proposed to the National Association of Insurance Commissioners a new method of comparing insurance products. Brian Fechtel details his plan in "Fairer Product Comparisons," beginning on page 18.

Next Month's Focus: Tax Planning



FAIRER PRODUCT COMPARISONS

BRIAN FECHTEL

Because of a compelling need to improve information about life insurance, a new policy-disclosure and cost-measurement approach recently was submitted to the National Association of Insurance Commissioners and the Society of Actuaries. Although we live in the age of information, we remain mired in the Stone Age when it comes to providing data about insurers' practices and performance so that consumers may understand and compare policies.

To correct this situation, life insurance policies should be separated into two operational components—compounding rates and costs. This can be achieved by using an approach called fungible present-value analysis. Implementing this approach will benefit the industry in many ways, including helping it to achieve its primary purpose: to appropriately insure all who need coverage.

Last spring, a Society of Actuaries' task force investigating illustrations confirmed the need for improved information about policies and insurers. It reported that more than 95% of the companies responding to a survey perceive a problem with current industry sales illustration practices in terms of communicating with the potential buyer in good faith. In addition, in the past year articles in many publications, citing significant consumer dissatisfaction, have issued warnings about life insurance policies.

Recently, for example, a jury in Texas awarded a plaintiff $55 million after an insurer was ruled to have affirmed an agent's fraudulent misrepresentations of a life insurance policy by issuing the policy. More compelling than instances of unfavorable publicity, perhaps, are the industry's own replacement regulations, which attest to the product's current ignominious unintelligibility for ordinary individuals. However, on the positive side, the American College recently completed a questionnaire

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fungible present value of the 20th year's cash value equals $19,132. That the sum of the FungPV costs and FungPV cash value equals the FungPV premiums is neither coincidence nor tautology.

Although costs were calculated from this difference in the preceding explanation, if one were to calculate the present value of the illustrated policy's implicit annual costs by using the detailed annual cost data provided in a universal policy, one would see that this value equals the figure calculated above, with the difference. This equality is achieved because the same interest rate used in compounding the original illustration is used in discounting it. Indeed, to use a different rate for discounting than for compounding would be to impute profit or loss into the analysis. Only identical compounding and discounting rates maintain the actuarial integrity of this analysis by preserving the validity of the actuary's identity that benefits equal costs.

The fungible present-value table and graph show the allocation of premiums and their earning power to the benefits of cash value and protection. For instance, within this illustrated 8% compounding-rate system, the fungible present value of premiums paid for 30 years is $30,420, of which $8,941 is expensed for insurance-related costs, leaving $21,479 as the fungible present value of the future cash value. Admittedly, these are not absolute values, but rather relative, illustrated values within this investment/cost system. Consequently, a competitive assessment of these values requires substantiating and comparative information about their reasonableness, reliability, appeal and the like. Nonetheless, fungible present-value analysis clearly highlights that, from the policyholder's perspective, a good life insurance program depends on having a competitive compounding rate and a competitive cost, or sufficiently superior performance in one area to offset comparatively poorer results in the other.

Fungible present-value analysis highlights that a good life insurance program depends on having a competitive compounding rate and a competitive cost.

Even though this analysis can effectively dissect an illustration or an actual policy's historical summary, it is important to note the few rules and caveats for using the fungible present-value approach. First, the actual protection received in this illustration varies from year to year because the application of dividends to purchase paid-up additions increases the at-risk amount and, correspondingly, the growth in cash value decreases it. Consequently, to facilitate legitimate comparisons of various policies, insurers could disclose illustrated FungPV costs for each policy's first 20 or 30 years, based on a constant at-risk amount equal to the initial face value.

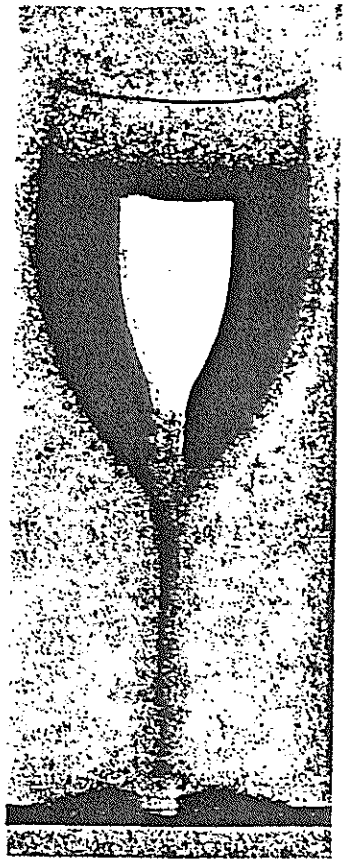
Second, and most important, FungPV figures are directly comparable only if they are derived for the same compounding rate and duration. Although it is possible, after making a few assumptions and many calculations, to translate FungPV figures at one compounding rate or duration into estimates at another rate or duration, doing so goes beyond the purpose here. As a practical alternative, the industry could prepare tables of virtually equivalent FungPV costs at various compounding rates and durations for selected initial ages and at-risk amounts.

Another caveat of FungPV analysis of illustrations is that the calculated cost value is based only on the insurer's chosen assumptions: The results derived are merely illustrative. The acknowledgment of this fact is an important advantage of this approach precisely because it encourages evalua-

CONTINUED ON PAGE 87

on company and policy practices.

These and other developments demonstrate that the most important goals of 20 years of regulation—informed buyers, intelligible policies and genuine economic competition—have not been achieved. Such a finding is hardly surprising, considering that the industry's primary tool for policy information—interest-adjusted indexes—is not only inadequate, but also both regularly misused and misunderstood. For instance, comparisons of interest-adjusted indexes of dissimilar insurance plans are invalid; hence, the index is a limited tool in times of tremendous policy diversity. Equally as remarkable, though, is the incomplete explanation—indeed, often times inexplicable omission in the industry's and regulator's consumer literature—that the disclosed indexes are merely derived from illustrated scenarios that are not required to be reasonable or reliable.



The effort to make the policies tangible through illustrations has made them unfathomable because their operating components have been obscured. Currently, consumers, as well as agents, are neither informed of insurers' assumptions about these components nor provided relevant information to facilitate an evaluation. However, as Joseph Belth, the universal life pioneer James Anderson and the late Albert Linton have shown, the separation of policies into cost and compounding components is easy: The challenge, however, is to present the results accurately and intelligibly.

A NEW WAY

It is here that fungible present-value analysis plays an important role. Fungible present-value analysis begins with the observation that if the same stream of premium dollars invested in a life insurance policy were put into an investment vehicle earning at the same annual compounding rate and having the same tax advantages, the cash value in the alternative investment would exceed the policy's cash value because of the cost of the life insurance component. Life insurance, after all, requires annual mortality charges to cover death claims and typically involves higher setup costs, such as underwriting expenses and larger sales loads. Fungible present-value analysis states that the total of these life insurance costs is best understood by examining the difference between these future cash values—the policy's and the alternative investment's—and expressing it as a present value by using the compounding rate as a discount rate.

This approach is called fungible present-value analysis because the use of the same rate for both compounding and discounting preserves the interchangeability or fungibility of dollars at different times within the "investment/cost system." This fungibility is critically important to the accuracy and completeness of the approach. The system's compounding/discounting rate is defined as the rate of return on the insurer's investment portfolio net of allocated investment expenses: in essence, the net interest or dividend rate credited on cash value. (Although this expense allocation is logical and complies with accounting principles, the validity of fungible present-value analysis does not depend on this compliance; a gross investment rate of return could have been used, and the investment expenses could have been aggregated with the product's unique insurance-related costs.)

The accompanying whole life policy illustration uses an 8% dividend or compounding rate. Supplementing this standard summary, column B shows the cash value of an alternative investment with an identical compounding rate and tax-deferred appreciation. After 20 years, for example, the cash value of the alternative investment is $34,483 greater than the policy's. Using this difference and the 8% compounding rate as a discount rate, we calculate that the illustrated fungible present-value cost of this policy is $7,398, or, in complete FungPV notation, where it is necessary to note compounding rate and duration, costs (8% & 20) = $7,398. The illustrated FungPV costs at 10 and 30 years equal $6,164 and $8,941, respectively. In essence, these figures show the present sacrifice—the policy's internal economic opportunity cost—that a policyholder would make for the insurance protection in the illustrated scenario.

ACTUARIAL INTEGRITY

Applying fungible present-value analysis to premium streams, cash values and death benefits provides other useful insights about life insurance. Discounting the 20-year stream of premiums yields $26,530, while the

Whole Life Policy

$200,000 Face Amount
30-Year-Old Male
Dividend/Compounding Rate = 8%
Dividends to Additions

Annual Premium = $2,502					
End of Year	Insurance	Dividend	Cash Value Total	Cash Value Guaranteed Minimum	Column B
1	$200,116	$ 20	$ 20	$ 0	$ 2,702
5	206,466	503	8,816	7,482	15,852
10	226,662	1,316	25,836	18,926	39,145
15	258,396	2,262	51,844	32,908	73,369
20	297,115	3,335	89,173	49,900	123,656
25	363,473	6,893	142,066	65,718	197,544
30	450,334	10,265	216,136	82,548	306,109
35	563,750	15,229	319,432	100,088	465,628

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tion of the assumptions. For example, in the accompanying graph, additional cost curves could be drawn that would represent, for example, the fungible present values of the guaranteed maximum costs, ordinary mortality costs from the commissioners' standard ordinary table or any other cost assumption in an 8% investment environment. Consequently, judgments can be made about the attractiveness, reasonableness and reliability of illustrated assumptions.

The analysis explains the operation of a life policy in consumer-friendly terms.

A final caveat addresses the challenge of applying this approach to historical results, in which regular changes in the compounding rate occur from period to period. The solution is to calculate the mean annual compounding rate—as though the policy were simply an investment vehicle—and to use this rate to calculate the fungible present-value cost. Like anything that uses an average, this solution has limitations, but they are relatively insignificant.

CLARITY AND COMPREHENSION

The focus of fungible present-value analysis on the two critical components of a life-insurance policy directs attention to the areas worthy of assessment. It explains the operation of a life insurance policy in consumer-friendly terms and facilitates analysis of related issues. Consequently, the previously unfathomable subject of policy analysis becomes relatively simple and capable of intelligible discussion.

Compounding rates, after all, are comparable with other interest rates, such as those for certificates of deposit, bonds, mortgages and mutual fund annual growth rates, which are familiar to consumers. While the cost figure is a multiperiod present-value aggregate, and therefore different from everyday costs, it is interpreted and used in the same way as other ordinary costs. The concept of present value can be explained by demonstrating the advantage of receiving $100 now rather than $100 in five years or, alternatively, the discounting of a 10th year's cost to a different value in each preceding year. Furthermore, if the industry were to use the fungible present-value approach, it could move beyond the simplistic disclaimer on illustrations, that the values do not reflect the time value of money, and begin to convey an understanding of a policy's distribution of costs and benefits over time.

However, this approach conveys something more important than the measurement of an illustration's compounding rate and its costs: It provides an impetus to search for information that is relevant to assessing insurers' future performance. While this approach does not eliminate uncertainty, it can facilitate informed discussion of performance. In the future, life insurance buyers, much like those who enter into other types of long-term investments and expense contracts, could have improved information about illustration assumptions, historical performance, quality of management, implementation of new practices/strategies and the like.

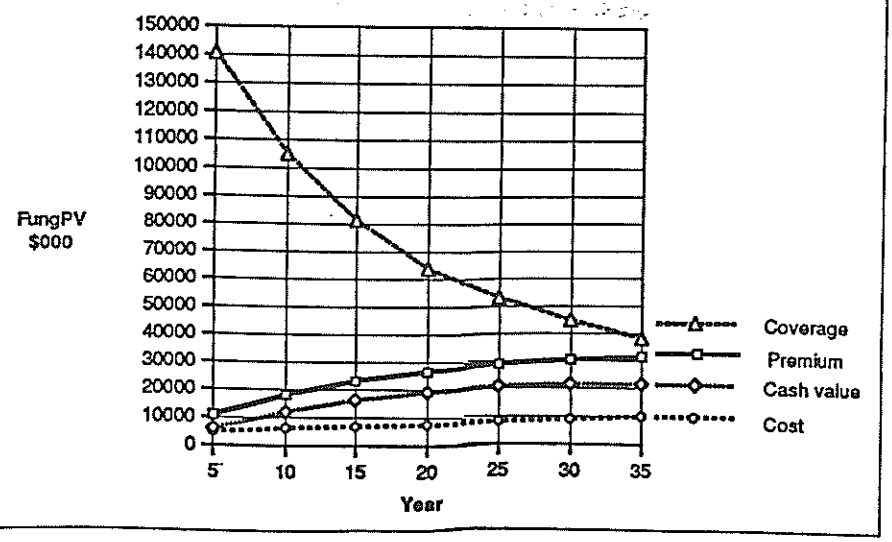
Another significant advantage of fungible present-value analysis is that it can be applied to any form of cash-value life insurance, whole life, universal life, variable life, graduated premium policies and, assuming a discount rate, even to term insurance. This enables cost comparisons among many types of life insurance policies and reveals that no particular type of policy has eliminated the annual costs of mortality. Consequently, it dispenses with the seemingly simple and informative, but simply misleading, notion that there are two types of life insurance: term and whole life.

There is only one type of life insurance, but policies have many different features and structures. Subsequently, greater consideration will be given to these features and structural differences among policies. For instance, cash-value policies' tax-deferred (and possibly tax-waived) appreciation will be valued for enabling costs to be paid with pretax dollars; universal policies' flexible premiums will or will not be attractive because of their flexibility, and issues, such as mutuality, the insurer's investment objectives and expertise and agent services, will become increasingly important.

The simplifying policy-presentation approach of fungible present-value

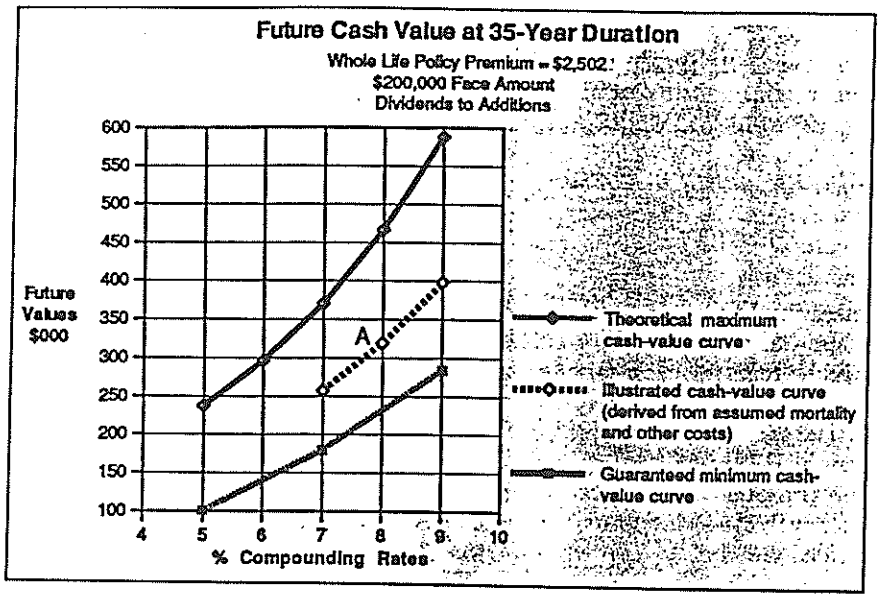
Fungible Present Value for Whole Life Policy

Year	Premiums	Cash	Cost	Coverage
5	$10,788	$ 6,000	$4,788	$140,517
10	18,131	11,967	6,164	104,988
15	23,129	16,343	6,785	81,457
20	26,530	19,131	7,398	63,745
25	28,845	20,744	8,100	53,073
30	30,420	21,479	8,941	44,753
35	31,492	21,604	9,887	38,129



analysis also makes it possible to produce future cash-value graphs—another advantage of this approach. Specified for a particular duration, these graphs show the impact of compounding rate and cost assumptions on future cash value. In the illustration of future cash value at 35 years, the top curve indicates the maximum cash value—an unrealistic maximum for a life insurance policy because it implies zero costs—after compounding 35 years of $2,502 premiums at the rates shown.

Similarly, minimum cash-value figures have been plotted as the bottom curve, based on the maximum assumed costs at various compounding rates. Point A illustrates the 35th year's cash value of the described whole life policy with its implicit cost assumptions and 8% compounding. A curve roughly symmetrical with the other two curves has been drawn through point A, illustrating the cash value of this policy under identical cost assumptions but different compounding rates. The difference between point A and the corresponding point on the maximum future cash-value curve is approximately $146,000, which discounted at 8% equals the fungible present-value cost originally calculated for this policy. Both fungible present-value and future-value analyses offer the advantage of evaluating all costs and benefits from one time period, either the beginning or the end.



BUILT-IN INCENTIVE

Future cash-value graphs can help to explain the interaction between cost assumptions and compounding rates in producing a future cash value. In particular, this kind of graph shows that many combinations of costs and compounding rates can produce a given future cash value. In addition, such a graph demonstrates that if, for example, it were falsely claimed that a high compounding rate had been achieved during a particular period, the actually achieved cash value would imply a correspondingly high cost. Any attempt at a favorable misrepresentation of one component of past policy performance is offset by an unfavorable representation of the other component, indicating this system's built-in incentive for accurate disclosure.

The information this approach provides will affect industry participants in many ways. For agents, it will provide a simple but powerful means of explaining policies and delivering objective and quantified information. It can be used to evaluate insurance/investment strategies, for example, early mortgage payoff or college funding; estimate short-pay or vanishing-premium periods under alternative compounding rates; reveal lapse-enhanced illustrations; and incorporate tax considerations into a client's analysis. However, it also will necessitate reassessment of some typical selling approaches, such as owning versus renting, buying early or buying when young and explaining the increased cost of all rated policies.

For consumers, the improved understanding of policies and the increased ability to compare insurers—in their new offerings and existing policies—should lead to greater satisfaction. Confident of receiving intelligible answers, consumers will be able to ask the two most important questions about a policy: Is it likely to provide a competitive return, and is it likely to charge a fair price? Agents will be able to answer with facts, references to results and other relevant information. In contrast with the ways in which some promote life insurance and others criticize it, life insurance is neither a "something for nothing" transaction, nor a "nothing for something" exchange.

The evaluation of a policy's competitive value is always a comparative subject. But, just as spotlighting policies' operational components will lead insurers to improved performance, understanding policies will lead to greater consumer confidence. Once their questions have been answered satisfactorily, consumers can search for policies with structural features and other benefits suited to their needs. This should then lead to fewer lapses—a situation that represents better value not only for consumers, but also for both agents and insurance companies.

For insurers, fungible present-value analysis has implications for product development, agent compensation and many competitive and strategic-planning issues. In the late 1970s, the industry lobbied Congress to prevent publication of the Federal Trade Commission's report on life insurance which, from the industry's perspective, answered the two central consumer questions with erroneous negative responses. Certainly, the industry had good reason to object to this report, but in not responding to critics with explicit justification for results, the industry—the second-largest provider of capital in the nation—has allowed itself to be perceived as a second-rate investor with unnecessarily high expenses.

Only after demonstrating the quality, value and integrity of its products will the industry command respect and seize initiative, as it must, to address its primary concern: the inadequate life insurance of most breadwinners. Clearly, creative new approaches to change consumer perceptions about life insurance are needed. The promise of the future can be realized only after the industry affirms its intent and capability to provide competitive returns and fair prices. This is what fungible present-value analysis does and why it offers the industry, agents and the public exciting prospects. BR