The Life Industry's Policy of Confusion

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It seems likely that when the industry's history is reviewed, 1992 will be recognized as the year that the industry's No. 1 sales aid - the policy illustration was declared defective, and the industry's quality measurement defective, and the industry's quality measurement tools – the indexes- were recalled.

Magazine contained drawing of an agent pushing a two foot high pile of papers across a table to a consumer.

PERSPECTIVE

The statement "In the current marketplace involving life insurance sales, there is virtually no accountability for any participant in the sale," may sound like exasperated hyperbole from a Florida insurance official tired of investigating the recent Met Life sales abuses or a routine comment from an industry critic. It's taken, however, from the National Association of Insurance Commissioners' Life Insurance Disclosure Working Group's position paper issued in September 1993. As shocking and sensational as the Met Life sales scandal has been, the NAIC statement alludes to the real scope of the industry's enormous sales practices problems.

While some have sought to attribute recently uncovered sales abuses to a small group of renegade agents or a broader but still narrowly defined category of sales tactics, doing so will result in missing the tremendous opportunities these problems reveal. Similarly, others, when confronted with previously publicized industry problems, such as replacement practices, lapses and inadequate coverage, have treated symptoms rather than trying to heal the core problem.

Consequently, the life insurance industry's core problem – its marketplace's failure to satisfy the requirements of genuine economic competition- remains. Its paramount shortcoming is in the absence of the information required to understand and evaluate policy value and performance. Unfortunately, the void created by this absence is regularly filled with abundant misinformation. This undermines the opportunities for meaningful communication. Fortunately, these problems are solvable. While the transition will be costly to some, substantial rewards will come to market participants capable of successfully changing a few standard operating procedures.

Since the cost and performance of cash value policies are neither properly explained nor appropriately reported, consumers fail to adequately understand and compare policies. For instance, the standard practice on whole life policies is to disclose dividend results, but dividends are a convoluted performance measurement because they are a function of premium size, guarantees, and the combined results of costs and investments. Alternatively, information about universal and variable life policies may either omit vital information about a policy's implicit costs or provide summaries so disjointed that they discourage all but the most mathematically inclined and determined policy sleuths from pursuing such necessary information. While the life insurance industry asks policyholders for more than $80 billion a year in premiums, it responds to the subject of reporting and accountability the way George Bush does to broccoli.

For some time the industry has treated the information problem as though it were limited to illustrations. Two years ago the Society of Actuaries criticized illustrations for failing to communicate in good faith. Subsequently, some have sought to limit illustrations and their uses. Others have tried to create "good" illustrations. Last month the NAIC proposed allowing only guaranteed or historical results to be illustrated. These efforts will miss the mark. Without a basic understanding of policy mechanisms and the various possible assumptions embedded in illustrations, every one is misleading.

The industry was jolted in December 1992 when the American Academy of Actuaries recommended that it no longer disclose the interest adjusted indexes of sale illustrations – the

industry's purported measurements of policy quality. For the past 20 years, the industry's own consumer education brochures, including the American Council of Life Insurance's Consumer Product Buying Guide, have instructed in bold face type: "Remember, look for policies with lower cost index numbers." But such mandatorily disclosed indexes, unintelligible to ordinary consumers and agents, have been and continue to be based on flawed illustrations. Believing that such indexes, based on numerous insurer-chosen and undisclosed assumptions could be useful to consumers for comparison shopping is as ludicrous as saying that transcripts made by high school students in their print shop would be useful and relevant to college admissions officers. It seems likely that when the industry's history is reviewed, 1992 will be recognized as the year that the industry's No. 1 sales aid - the policy illustration was declared defective, and the industry's quality measurement tools – the indexes- were recalled.

Many knowledgeable observers have been baffled that it took the industry so long to recall the indexes. Promulgated in the midst of congressional investigations in the early 1970s to stave off further federal pressures and actions, these purportedly useful and comparative measures have been flawed on several conceptual bases from the start. First, the surrender cost index attempts to define what is at least a two-variable phenomenon with a single measurement. This is like trying to describe a rectangle with one measurement. Similarly, the payment index misleadingly combines the cost of coverage with the cost of endowment. Furthermore, the indexes' opacity and foreignness have made them subject to misunderstanding and manipulation. Finally, the industry's prohibition against comparing indexes of dissimilar policies – precisely the types of comparisons consumers most want – has made the figures practically worthless.

The actions of one industry body deserve praise for their intent if not their execution. Recognizing the problems with sales illustrations, the Society of chartered Life Underwriters and Chartered Financial Consultants formed an illustration disclosure questionnaire. Intended to significantly improve agent's understanding of sales illustrations – and life insurance policies in general- the so-called IQ questionnaire is a marked accomplishment. But the benefits of their efforts have been impaired by insurers' abysmal participation rate in completing the questionnaire and by the American College's own decision, because of antitrust concerns, not to disseminate insurer's answers.

The most important consequence of the absence of good information is the perpetuation of the industry's most treasured marketing myth. Consumer education brochures, printed by insurers at the mandate of regulators, tell prospective buyers there are two types of life insurance: term and whole life. While there are inherent challenges in making distinctions, this seemingly edifying dichotomy is both deceptive and harmful. Of course, many have pointed out that a whole life policy is merely a combination of term insurance and a savings program. Yet few consumers recall this observation when confronted by the brochure's black-and-white print or an agent's personal, distorted rendition of whole life's alleged advantages, thereby perpetuating the myth. Such disparagements as, "Term is just simply throwing money down a drain" or "In the future, your term rates will go through the roof" are incomplete, yet commonplace, sales expressions regularly taught in agent training sessions. Company sales brochures routinely ask, "Whey rent when you can own?" Agents typically continue this line of reasoning, asserting that not only is it better to buy than rent, but it is better still to buy early and at a young age because a lower cost is locked in.

The industry has not adequately explained that every insurance policy involves the acceptance of a little loss to avoid a possible big loss. With respect to life insurance in particular, attempts by industry authorities to explain the difference between policy costs and premiums – a distinction that must be understood if one is to correctly compare various policies- can be considered at best half-hearted and incomplete. Even after disclosure of the Snoopy sales scandal and the subsequent tough talk from regulators, the NAIC's draft of its Life Insurance Illustration Model Act seeks to prohibit misrepresenting the benefits, advantages, conditions or terms of any life insurance policy or annuity contract through misleading or incomplete illustrations.

Until there is disclosure of the basic policy mechanics, every sales presentation will remain incomplete and likely misleading. Indeed, the currently proposed prohibitions seem likely to be as limp and toothless as the prohibitions against comparisons of total premiums outlawed 20 years ago because of their failure to reflect the time value of money.

Although these comparisons are still routinely done, those published are now accompanied by a disclaimer about their uselessness.

It's important to note that the dissemination of misinformation about life insurance policies is hardly limited to the industry and its agents. Invariably, consumerists, in their typical rants about whole life, regularly mix valid and invalid criticisms that generally reveal basic misunderstandings about this marketplace and economics in general. Perhaps the best example of their routine valuelessness is *Consumer Reports'* recommendation in 1988 of Executive Life. Or consider their reaction last summer that consumers avoid "hybrid policies" – policies marketed as combinations of term and whole life- because of their own inability to help consumers distinguish between good and bad offering among such policies. At the same time, *U.S. News and World Report* published an article describing the advantages of such hybrid policies because of their flexible, virtually negotiable, loads.

Finally, consider the bobble-headed suggestion of another columnist who discouraged replacement of an existing policy because one has already paid that policy's load. She wrote that the reason switching policies almost never makes sense "is that you have already paid heavy upfront costs, the equivalent of 100% to 150% of the first-year premium. But after about five years, the policy has begun to work for you." Whether this writer needs more help with English or economics is debatable, but past costs are not relevant when assessing future options. The appropriate consideration examines the future costs of the various options. Admittedly, loading a new policy might not be justified, but that cost is different from the load that's already been paid. If the NAIC is concerned about prohibiting misinformation in the future, will it seek to impose sanctions on such columnists?

Admittedly analysis of cash-value policies can prove difficult to even financially astute analysts. While a cash value policy's tax-deferred inside buildup is often acknowledged, the cost advantage of this privilege is consistently overlooked. The fundamental cost advantage of cash value policies is their ability to internally fund the policy's inevitably high costs in the later years with untaxed appreciation. A potential second advantage is their comparatively lower future mortality costs – lower than those of term policy – but lower only because of whole life policyholders' traditionally greater renewal persistency. In contrast with the sales myth about whole life policies somehow locking in a lower cost, what is actually locked in is a health classification or funding level – not a cost. These real advantages are readily explainable and understandable. In essence, they do not violate the sales commandment to keep it simple.

Highlighting the fundamental cost advantage of cash value policies may well cause concern among many industry participants. In an informed and competitive marketplace, a firm cannot charge or extract a price for a free input. The congressionally given, tax-deferred inside buildup comes at no cost to the industry. But the industry is able to extract a price for it because of the misleading distinctions between term and whole life and the current market structure. That the industry needs to extract a price for this freebie is additional evidence that the market does not operate in an economically competitive fashion. Consequently, comprehensive reform will require not only the necessary information for good communication, but also changes in market participant's rights, obligations, bargaining privileges, and mobility.

Not only have the industry's informational problems caused an assortment of other problems, but the industry's continued avoidance or denial of its information problems is like a salesman who is ignoring a sincere persistent objection. As any good salesman knows, such objections must be dealt with both empathetically and directly.

Understanding a life insurance policy merely involves understanding its components. The basic performance components of a life insurance policy are its annual costs and, if it is a cash-value policy, its compounding rate and information about its investment approach. Other aspects of a policy, such as its premium flexibility and endowment/at-risk amount characteristics, are structural, not performance-related, features.

Admittedly, if one desires a contractually fixed-premium policy because of its imposition of mandatory/disciplined savings, then such a structure feature can assume increased importance. But, generally, when making a decision about a life insurance policy- similar to such other long-term vehicles as automobiles and mortgages- one is regularly concerned most about long-term performance.

In a life insurance policy, good long-term performance can be defined as comparatively low costs and a favorable average compounding rate. Given this framework, it is simple to plot these two

performance variables for various policies, comparing whatever one considers to be a useful proxy of each product's future performance. Subject to routine caveats associated with uncertainty, plotting a policy's two performance components, costs and rate, is necessary to begin to eliminating the life insurance marketplace's enormous information problems.

The industry has been reluctant – in fact, downright resistant – to having life insurance policies viewed as investments. Obviously, when one of the performance components of a cash-value policy is an unmistakable investment variable called compounding rate, such continued resistance will appear silly. The sooner this occurs, the better, for the industry has nothing to fear and much to gain from such a clear and accurate representation.

After all, the legitimacy of the industry's tax privileges arises from its product's purposes. It should not be jeopardized by the perception, understanding or disclosure of policies explicit investment component.

To make life insurance better, the system needs to be changed. Solving the industry's informational problem will have a profound effect on the marketplace, improving the industry by expanding the use and value of its products, increasing its competitiveness with other financial institutions, reconfirming the legitimacy of its tax-advantaged privileges and reversing the public's current dismal opinion of agents. Coordinating this with an examination of other important industry issues such as bargaining and mobility obstacles and incorrectly specified property right could lead to an industry renaissance.

Originally, this article was entitled, "Making the Transition to Proper Disclosure and Marketing of Life Insurance." An editorial change to shorten it and/or increase readers' interest, no doubt probably didn't earn the author any new friends in the industry.