MISLEADING PROMISES: BEWARE OF AGENTS BEARING GUARANTEES

By Peter Katt

The new sales gimmick in life insurance is the exaggerated secondary guarantee, which guarantees a specified death benefit if a specified annual premium is paid. These guarantees are not benign if they are the reason a particular insurance policy is purchased, while far more important criteria are ignored.

For too many insurance companies, permanent life insurance selling is a long-running game of "hide the pea"—using one sales gimmick after another to entice agents to sell their policies and attract buyers.

Policy illustrations have been a major player in this shell game as life insurance agents emphasize the importance and certainty of projected policy values, only to have customers disappointed as actual policy performance fails to meet the agents' ardent and frequently ignorant promises. These failed policy-performance promises are an old story chronicled frequently in this column and the subject of many class action suits.

THE NEW GIMMICKS

While exaggerated projected policy-performance promises are still being made, many companies have come up with a new gimmick—exaggerated policy guarantees. These exaggerated guarantees take the form of what is known in the business as secondary guarantees.

Secondary guarantees refer to guaranteeing a specified death benefit if a specified annual premium is paid. Not included are guaranteed cash values. Secondary guarantees can have various durations, depending on the company making them. For example, some may be to age 85, some to age 100.

Of course, policy guarantees are nothing new. All permanent life insurance policies have guarantees. Universal life type policies have guaranteed cost-of-insurance and interest-crediting components (but no premium guarantees, although they can be determined using the cost-of-insurance and crediting guarantees). Whole life policies have premium, cash value, and death benefit guarantees, but these conventional guarantees are far more conservative than the new guarantees. Indeed, the exaggerated guarantees are roughly twice as good as the conventional guarantees.

GOOD vs. BAD GUARANTEES

At this point, you may be wondering whether I have lost my mind in cautioning you about guarantees that are twice as good. Well, if I am becoming weak in the knees in the face of these exaggerated guarantees (my term), so also is the National Association of Insurance Commissioners (NAIC; www.naic.org). The NAIC has been trying to impose stricter policy reserve requirements (known as Triple X) to prevent companies from going too far with these secondary guarantees, and with cheaper and cheaper guaranteed level term costs.

Unfortunately, creative interpretations of these standards (in states where they have even been implemented) by many insurance companies has cast doubt about whether they will have their desired effect. We don't have to look back more than two years for an example, when the Oklahoma Insurance Department seized the insurance company Mid-Continent because its liabilities were exceeding its reserves due to exaggerated premium guarantees.

Peter Katt, CFP, LIC, is sole proprietor of Katt & Co., a fee-only life insurance advisor located in Kalamazoo, Michigan (616/372-3497; www.peterkatt.com). His book, "The Life Insurance Fiasco: How to Avoid It," is available through the author.

Exaggerated guarantees also caused the failures of Baldwin United and Equitable Life (in Great Britain). While I was not in on the meetings when these companies decided to set their unmet guarantees, it wouldn't be wild speculation to suggest they were set to give themselves an advantage over their competitors while imprudently assessing those conditions necessary for them to fail.

In a more dramatic sense, all policy guarantees (exaggerated and conventional) are worthless because insurance companies have no right to print money or maintain armed forces. As such, insurance companies have no ability to protect themselves against external events that could cause their guarantees to simply evaporate.

For example, if an uncontrolled airborne virus ravaged America, killing a third of the population, or a meltdown of the world economy occurred throwing us into anarchy (hello, Mad Max) all guarantees would be broken. Policy guarantees don't provide a floor beyond which policy values won't fall, they are merely a marker so we know exactly when they have been broken.

That said, there is a very important distinction between exaggerated and conventional guarantees. Conventional guarantees are generally based on mortality levels averaging, in my estimate, two to three times current levels, policy expenses about twice as high, and investment yields of 4%. This combination of pricing factors has never been experienced by life insurance companies. In other words, conventional guarantees would only fail in the presence of an unprecedented external catastrophe that would affect every life insurance company and every other facet of life as well. (Even the gross mismanagement of some companies during the 1980s that ended up with them being seized by regulators did not cause their policy values to fall below conventional guaranteed levels.)

But the financial failure of a company with exaggerated guarantees would not require such catastrophic events. Indeed, such financial failure would be due solely to the existence of these exaggerated guarantees themselves.

GUARANTEED PROBLEMS

Now let me be clear, I am not predicting the financial failure of insurance companies offering exaggerated guarantees because this is a remote, although visible possibility. In fact, perhaps a little noticed aspect of these exaggerated guarantees is that the companies directly offering them are backed in this pricing by their reinsurance companies. How the financial difficulty of a reinsurer affects individual policies is perhaps uncharted territory. Raising a caution about exaggerated guarantees because they will cause insolvency would itself be an exaggeration (I think). The far more notable problems with exaggerated guarantees are that they distract agents and clients from far more important issues when buying permanent life insurance, and they provide premium-certainty comfort that can lead to a long-term funding crisis.

As to the first problem, comparing insurance companies based on their guarantees (whether exaggerated or conventional guarantees) is a worthless practice that has unfortunately become quite popular due to the aftermath of the exaggerated projected policy-performance problem. For the past five years almost every case I have gotten involved in when a client has already received several proposals contains at least one agent making the argument that his recommendation is best because of better policy guarantees. And this usually is what the client and his other advisors are most impressed with.

THE RIGHT WAY TO CHOOSE

Choosing the preferred insurance company must be based on how competitive their current pricing is and on a judgment about whether their current pricing is legitimate—not upon who is making the best guarantees. The only way to know if current pricing is legitimate is by determining whether that particular company's pricing treats policies sold many years ago (20 years and longer) as fairly as pricing for the policy they are trying to sell you. This criteria ends up eliminating almost every company selling life insurance in America.

The short list of companies that appear to be treating new and old policies essentially the same includes the venerable old mutual companies Northwestern Mutual, Guardian, and Mass Mutual (but this can only be said of their participating whole life), and USAA's participating whole life (but not their universal life). I have not included companies that primarily sell interest-sensitive whole life and universal life because, while some of them do treat old and new policies the same (Ameritas Low-Load), their current pricing isn't nearly as good as the participating whole life policies sold by the aforementioned companies.

In stark contrast to companies that treat old and new policies with consistent fairness, are the vast majority of companies that constantly redesign their permanent life insurance to favor new buyers at the expense of existing policies. A week doesn't go by without some earnest insurance agent proudly proclaiming to me that his policy, just out of development, is the most competitive the company has ever sold. When I do some research on this company's permanent insurance policies what I usually find is that the older versions (and there may be five and more) have much higher cost-of-insurance rates and lower interest-crediting than the shiny new product, making their pricing pretty grim.

Life insurance isn't like a car, where improved design is welcome. We only keep cars for a relatively short period of time and then replace them with newer versions. Life insurance is a long-term asset that shouldn't need to be replaced. Therefore, basing a life insurance buying decision on the newest and best is a mistake. This gets me back to exaggerated guarantees: My experience suggests that the same companies that have repeatedly improved their new policies without giving these improvements to their old policies are also the ones offering these exaggerated guarantees.

The other problem, an imminent long-term policy funding crisis, will occur with exaggerated guarantees lasting to, say, age 85—because these exaggerated guarantees only apply to death benefits and premiums, not to cash values. Therefore, if an insured is alive and well at the witching-hour when the guarantee runs out and the policy's cash value has long since gone to zero, the policy will be the equivalent of term insurance at age 85. A policy whose annual premium has been $11,000 would now have an age 85 premium of $85,000 that will go up at the rate of about $10,000 a year—an amount unaffordable for many insureds, who would consequently see their policies terminate.

NON-BENIGN GUARANTEES

The conventional guarantees of life insurance are one of life's quaint euphemisms that provide many with a false sense of security without doing any harm.

Exaggerated guarantees are not benign if they are the reason a particular insurance policy is purchased, while far more important criteria that should be examined are ignored.

And for those who have already purchased exaggerated guarantee policies or who will purchase them, the danger is that insureds will outlive the guarantees and their policies' premiums will become so large that they can't be maintained. ✦