Minimum-premium-to-maximum-death-benefit vanishing-premium policies are inherently flawed, but there are other vanishing premium policy designs that can be useful.

Vanishing-Premium Policy Designs: The Good and the Bad

By Peter Katt

One of the leading causes of life insurance market misconduct is the so-called *vanishing-premium* concept. *Vanishing-premium* is a permanent or cash value life insurance policy design concept that features an estimated number of years the policy's premium might need to be paid directly by the policyholder to achieve a specified goal, such as policy endowment (where policy cash values and death benefits are equal) at age 100. The vanishing-premium concept was invented in the late 1970s and by the mid-1980s had become the most popular tool for selling life insurance policies. Almost all vanishing-premium policies sold during the 1980s featured the smallest amount of premiums paid for the fewest number of years to support the largest level death benefits possible at a time of historically high dividend rates. As dividend rates returned to more normal levels, the expected number of years the premiums would need to be paid under the vanishing-premium design rose dramatically. For example, it is common for a vanishing-premium policy sold during the mid-1980s that originally showed projected premiums for seven years to now have estimated premiums for 14 years to keep the policy from terminating. Such huge increases in expected costs come as a shock to many policy buyers because of the certainty with which they were sold.

Many of the life insurance agents selling the vanishing-premium concept in the 1980s had little or no perspective about how volatile it was because the professionally trained home office staffs didn't bother to explicitly explain to their agents how tenuous it is to promise a mixture of minimum-premiums-to-maximum-death-benefits, especially when insurance company investment yields supporting dividends are at all-time highs. It is my opinion that only a few agents actually promised policy performance that was essentially guaranteed, which would have been false. Rather, most agents probably did convey to vanishing-premium policy buyers a sense that dividends weren't guaranteed, but this communication lacked perspective because companies failed to properly train agents about how abnormally high their yields were and the overwhelming impact such yields had on projected premium vanish points. Indeed, many mutual insurance companies conveyed the opposite message by distributing brochures during the 1980s to agents that showed how much better their actual dividend payments had been compared to what was projected for policies they sold during the 1960s and 1970s—a time when the companies had been creating minimal dividend expectations. Against this backdrop it is likely that many agents, when disclosing that dividends were not guaranteed, were really conveying the idea that non-guarantees were good because this meant the policy could actually outperform what was being illustrated. Creating this kind of impression was historically inaccurate.

The enormous problems created by selling vanishing-premium policies during the 1980s has resulted in many companies having class action and individual suits brought against them. Some of these class action suits have been settled at apparent enormous cost to these companies. But I doubt that the vanishing-premium lessons have yet been learned. I suspect that vanishing-premium policy designs, even in an era of more normal insurance company investment yields, will continue to cause problems because of the illusion of certainty they create. Indeed, during the last week of December, I reviewed a vanishing-premium proposal from a major mutual insurance company that had an accompanying memo that stated, "$97,500/year for 15 years to fully fund $5 million." This statement is wrong because it creates certainty that simply doesn't exist.

However, not all vanishing-premium policy designs are inherently flawed. The balance of this column will distinguish between acceptable and unacceptable vanishing-premium policy

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designs.

Unacceptable Designs

A whole or universal life vanishing-premium policy design that features the smallest premium for the fewest number of years with the largest level death benefits based on current insurance company investment yields and mortality experience will absolutely require periodic adjustments to the premiums. The problem is that the commission-motivated system for selling life insurance has little financial incentive to properly monitor and manage policies once they have been sold and the large first-year commission has been received. The result is that the vast majority of minimum-premiums-to-maximum-death-benefits vanishing-premium policies that have been sold are left to twist in the wind and will ultimately get into trouble. One form of trouble is that investment yields will fall below the level they were at when the policy was purchased. When this problem is finally discovered, the amount of the premium shortage could be very high on an annual basis, causing the policyholder simply to surrender the policy in frustration. Another problem is that investment yields could go higher, meaning that the policyholder could actually overpay for the coverage if not properly monitored.

Vanishing-premium policies that have minimum-premiums-to-maximum-death-benefits are even more risky when sold as variable life (cash values can be invested in equity or equity-combination mutual funds) because of the greater year-to-year investment volatility inherent in equity investments. When policy cash values are invested in equities, even if a historically strong average return is maintained over a long period of time, the timing of market fluctuations will have a very significant effect on variable life policy performance and will potentially cause huge unexpected premium adjustments when associated with this unacceptable vanishing-premium design. For example, the *projected* premiums for a $1 million level death benefits variable policy that will endow at age 100 with an assumed 10% constant investment return for a 35-year-old-male non-smoker are $6,400 paid for 10 years. However, if during the first 20 years the average investment return is indeed 10% but consists of a 40% *decline* during policy years 18 and 19, premiums of some $11,000 would have to be paid from policy years 20 to 30 in order to prevent the policy from terminating. This is a doubling of expected policy costs calculated on a present value basis due solely to the timing of market fluctuations without any change in the average investment return assumed.

All variable life illustrations are horribly misleading because the SEC requires them to show a constant investment return, which completely misses the reality of how volatile equity investment returns are and the impact this volatility has on policy performance and therefore premiums. Using variable life policy illustrations with a minimum-premiums-to-maximum-death-benefits vanishing-premium design is a logical absurdity and should always be avoided.

Acceptable Design

The vanishing-premium design I find acceptable is one that features very high annual premiums paid for a specified period of time, with modest initial death benefits. Table 1 shows such a design for a low-load universal life policy, with annual premiums of $25,148 paid for 15 years with an increasing $500,000 death benefit for 15 years, then level death benefits thereafter, for a 50-year-old-male. At the current interest crediting rate of 6.4% by age 85, the cash value is $2.18 million, and the death benefit is $2.29 million. If the interest crediting rate falls to 4.5% and remains there, by age 85 the cash value is $1.2 million and the death benefit is $1.26 million. While the actual performance of the policy is understandably lower when the presumed interest crediting is lower than what was projected, the policy is never in any danger of terminating. This maximum-premiums-to-minimal-initial-death-benefits vanish-

Table 1.
Maximum-Premiums-to-Minimal-Initial-Death-Benefit Vanishing-Premium Policies: An Example

Assumptions and Policy Design:
- For a 50-year old male;
- $500,000 face amount
- Death benefits equal face amount plus cash value until age 65 then level, increasing when the cash values force the death benefits to rise
- Premiums of $25,148 per year for 15 years then zero premiums

		6.4% (Current) Interest Crediting Rate		4.5% Interest Crediting Rate	
Policy Year	Age	Cash Value ($)	Death Benefit ($)	Cash Value ($)	Death Benefit ($)
5	55	140,688	640,688	132,846	632,846
10	60	329,790	829,790	295,679	795,679
15	65	595,477	1,095,477	504,235	1,004,235
20	70	808,296	1,095,477	616,322	1,004,235
25	75	1,121,015	1,199,486	755,579	1,004,235
30	80	1,568,323	1,646,735	942,811	1,004,235
35	85	2,179,586	2,288,565	1,197,929	1,257,825
40	90	3,005,762	3,156,051	1,510,513	1,586,039
45	95	4,162,817	4,204,445	1,912,824	1,931,952

ing-premium design is also safe to use for low-load variable universal life where the year-to-year investment return volatility is much greater than with whole or universal life, because the amount of premiums relative to minimal initial death benefits would almost certainly prevent the variable life policy from ever being in danger of terminating. This maximum-premiums-to-minimal-initial-death-benefits vanishing-premium design defines the premiums paid but doesn't define the future policy values—they will be whatever they are. This is identical to a defined-contribution pension plan. This is distinctly different from the minimum-premiums-to-maximum-death-benefits vanishing-premium design, which tries to define both the premiums and the future policy values.

The maximum-premiums-to-minimal-initial-death-benefits vanishing-premium design is ideal for individuals whose income will drop dramatically at retirement and who want to pre-fund a policy that combines family protection death benefits with tax-deferred investing via the policy's cash values in order to be used as additional retirement income. It is also ideal for those who want to transfer wealth outside their estate with funds earned before retirement.

Conclusion

The vanishing-premium policy design with maximum-premiums-to-minimal-initial-death-benefits, which can also be described as a superfunded policy, is an acceptable way to provide death benefits and tax-deferred accumulations or to transfer wealth out of an estate. However, the minimum-premiums-to-maximum-death-benefits vanishing-premium design favored by most life insurance agents and companies is inherently flawed and should be avoided. When maximum level death benefits are needed, a better approach is to pay premiums continuously, rather than trying to concentrate the policy funding into a short period of time. This will allow for much better policy management because periodic adjustments to the amount of premiums will be much smaller due to the continuous premium pattern.

Every purchaser of permanent life insurance, whether it be whole life, universal life, or variable life, must understand that the only certainty is that the actual policy performance will be different from what is projected at the point-of-sale and in subsequent reviews because performance depends on investment yields, mortality experience, and policy expenses—factors that change. If the amount of the premiums paid is defined, the actual policy values will be different. If the amount of the policy values is defined, the actual premiums paid in the future will change.

All cash value policies require monitoring in order to make adjustments as new conditions dictate. This is the reality of cash value life insurance, and suggestions to the contrary are false.

Correction to the Insurance Products Column from the November 1997 *AAII Journal* "A Reality Check: Do You Need to Buy Long-Term Care Insurance?"

Table 1 on page 25 in the November 1997 Insurance Products column contained an erroneous number for the typical annual premium for long-term care insurance with 5% simple inflation protection at age 65. Below is a revised table with figures extrapolated from several sources. These new numbers don't represent any particular company, but are a compilation. Also, keep in mind that this chart is only a rough guide to pricing. I apologize for the inconvenience this error caused.

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Corrected Table 1.
Annual Premiums for Long-Term Care Insurance

	Age				
	55	60	65	70	75
No Inflation Protection	1,340	1,740	2,600	4,160	7,500
5% Simple Inflation Protection	2,680	3,130	4,240	6,530	10,880
5% Compound Inflation Protection	2,850	3,480	4,680	6,860	11,250

Note: Premiums based on $200 per day nursing home coverage and $100 per day home care coverage. Lifetime coverage with a 100-day waiting period.