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small Face Amount Policy Legislation

by Alex Zeid

Some states are considering legislation to correct perceived abuses in the small face amount market. For example, one bill recently introduced would have required an annual policyholder notification with the policy becoming fully paid up if the policyholder could not be located. It also would have required benefit enhancements of certain types of policies if the premium payments reached certain levels. Finally, the bill would have prohibited the delivery or issuance of industrial life insurance policies after a specified date.

We believe that adoption of these requirements would actually hurt consumers because the availability of small face amount insurance could be greatly reduced. Even if carriers continue to sell such policies, costs are likely to increase significantly as a result of the additional mandated death benefits, higher administrative expenses and potential fraudulent activity that will result.

Paid-Up Benefits

One proposed bill (Florida Senate Bill 1786) states that each insurer with an in-force policy of $15,000 or less must annually disclose the cumulative amount of premiums paid, the cash value and death benefits available. If the insurer is unable to locate the policyholder, the policy must be converted to fully paid-up status. This provision could lead to significant fraudulent activity if policyholders decide to make it difficult to be contacted soon after purchasing coverage, leading to automatically paid-up policies and ultimately resulting in higher premiums for those policyowners who continue to allow themselves to be found. The administrative costs of tracking down policyholders could become excessive. We are assuming that, in this context, "fully paid-up" means the full policy face amount is paid up, not the amount of reduced paid-up insurance as required by the Standard Nonforfeiture Law. In addition, the Florida bill would discriminate against the policyholders with face amounts exceeding $15,000 since this provision would not apply to them (leaving them without paid-up policies under these circumstances or the disclosure).

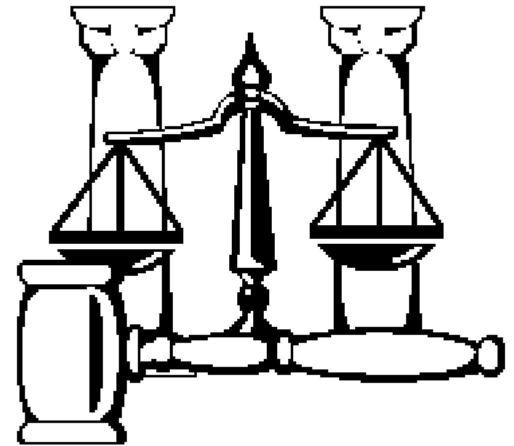
The bill is silent about the effect on policy reserves when a policy becomes fully paid up. Current in-force policies were not priced for this type of benefit, and reserve increases could result in solvency problems. It is obvious that this provision is unsound, and that there is no logical reason for providing such benefits, and it does not add anything to the Standard Nonforfeiture Law whose intent was to guarantee that policyholders receive an equitable value in the form of reduced paid-up insurance or extended term insurance whenever termination occurs, for whatever reason it occurs.

Benefit Enhancements

Florida Senate Bill 1786 would have specifically required, for policies issued after July 1, 2001 with a death benefit of $15,000 or less, the following:

- When the cumulative premiums paid exceed 250% of the death benefit, the insurer must enhance the death benefit by $0.50 for each premium dollar paid in excess of 250% of the death benefit.

- When the cumulative premiums paid exceed 500% of the death benefit, the insurer shall enhance the death benefit by $1.50 for each premium dollar paid in excess of 500% of the death benefit.



As a result of our testing, we have concluded that such benefit enhancements would drive up prices significantly on products designed to meet these requirements. Products that include the proposed enhancement provisions would be difficult to price, since benefits are tied to the premium. This type of benefit is a more complex and less understandable variation on the return of premium benefit provisions found in some policies.

Return of premium benefits result in significantly higher premiums, particularly for smaller policy sizes and at older ages. There would also be additional costs to the insurance company as a result of the need to price new products with the new benefit provisions, develop and file new policy forms and calculate new cash value and reserve factors. We do not believe that insurers could have had new products and administrative systems in place for a July 1, 2001 effective date. For small companies, these costs may make selling these products prohibitive resulting in reduced availability of these policies to the consumer and less competition in the marketplace.

Another consideration that is not being taken into account is that the policyholder has often accrued a significant cash value by the time the premiums exceed the current death benefit. This

accrued value is a real, tangible benefit that should be considered as an offset to any perceived losses from the accumulated premiums exceeding the current death benefit. If a policyholder decides that he no longer needs the death benefit coverage and surrenders the policy, the net payment equals accumulated premiums less any cash value received. Indeed, as premiums increase due to issue age, the corresponding cash values also increase.

We calculated premiums with and without the enhanced benefit option and found that the enhanced benefit option would increase prices to a greater extent as the issue age increases, thus harming the older consumer. Extremely large price increases would occur at the oldest ages where premiums are already necessarily high due to age. These older consumers often have no other available insurance alternatives because of underwriting considerations and the lack of term insurance availability at these ages.

In addition to making the policy more expensive, we found that the enhanced benefits actually would cause the perceived problem to happen at younger issue ages than it otherwise would have: in other words, the increase in the premiums necessary to produce the enhanced benefit would result in premiums exceeding death benefit that much more quickly. It would be a vicious cycle.

In addition to the costs of repricing and implementing new products, the administrative costs associated with this type of benefit would also be significant, particularly in light of the complexity of the calculations that would be required on an individual policy basis. Since the death benefit is directly related to premiums paid (an amount which may include varying premiums for riders and policy fees), death benefits can no longer be calculated from pre-calculated tables of values that are stored on the administrative system. Instead, death benefits would have to be calculated and stored for each individual policy. This would require a major upgrade to administrative systems or have to be done by hand. The alternative would be for companies to eliminate or significantly restrict the availability of supplemental benefits and riders and to create complex, non-policy fee banded premium rate structures, which would also increase costs and reduce value to the policyholder.

We believe that there are sound actuarial reasons for life insurance policies to have cumulative premiums that exceed benefits paid in later years. For those unfortunate individuals who die in the early policy years, they receive more in benefits than were paid in premium. On the other hand, those who survive pay for these early death claims and may ultimately pay more in premium than they receive at time of their death. This is fundamental to any risk pooling concept. This does not mean that these policies do not provide value to the consumer.

Indeed, the basic tenet of any kind of insurance is that you pay a premium for something that you hope you won't need to collect on. By its very nature, whole life insurance will provide benefits in excess of collected premiums to some insureds *and* will also collect premiums in excess of benefits from other insureds. The key to making sure that the consumer receives sufficient value is to make sure that he or she understands this tenet and takes it into consideration in the purchase decision.

> ***"The best time to make sure that a policyholder understands what he is buying is when he is buying it."***

Conclusion

We understand the concerns being expressed about policyholders who may purchase life insurance policies and later feel that they did not receive the value that they paid for because they didn't die early. When that misperception occurs, it is not good for anyone involved.

However, the approaches being considered by some regulators are not only an unreasonable burden on the carriers who sell policies in this market, but they are also ineffective and unnecessary ways to address these concerns. The ultimate result would be the inability of insurers to provide these small policies to those who need the protection the most, i.e. those who are unable to afford larger insurance policies due to financial, age, or health limitations.

The best time to make sure that a policyholder understands what he is buying is when he is buying it. That is when the policyholder can and should make decisions whether or not to purchase a policy or to use his "free look" provision to return a policy. For most small policies, the relationship between premiums to be paid and benefits payable over the life of the policy, at least on a guaranteed basis, are easily determinable at issue.

Attempts to solve what is essentially a disclosure problem by adding an expensive layer of hard-to-understand post-issue disclosures and complicated, hard-to-understand mandated future benefits are not reasonable remedies, but would actually hurt those that the regulators seek to protect.

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