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Life insurance sales illustrations — What are the problems?

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The emerging life insurance sales illustration crisis has been receiving more attention every day from actuaries, regulators, industry watchdogs, and others. Proposed regulatory measures seem not to address the problems directly. This article is an effort to provoke discussion and ideas which directly address these problems.

The problems involve more than just the use of unrealistic interest rates. There are many ways to enhance sales illustrations. Let us first describe a product of a hypothetical company that does not contemplate any product "enhancements." This universal life product is currently receiving 8% interest and has cost-of-insurance rates equal to 60% of 1965-70 ultimate mortality (for a male nonsmoker age 45). A 5% load is deducted from each premium, and a fee of $5 per month is deducted from the account value. There are no other front-end charges. The product has reasonably competitive surrender charges and produces a reasonable (but not excessive) expected profit margin under aggressive, but reasonable, current pricing assumptions. The company's illustrations reflect the above-described product features.

Now let us look at a few enhanced illustrations:

(a) The illustration is like the first, except that the company illustrates no 5% load or $5 fee after year 15.

(b) The illustration is like the first but uses mortality that improves 2% per year, with the company correspondingly reducing c.o.i. rates starting in years 16, 21, 26, etc. (i.e., by 30%, 10%, 10%, etc.).

(c) The illustration is like the first but includes a bonus in year 16 equal to all the charges deducted during the first 15 years and a bonus in year 26 equal to all charges deducted in years 16 to 25.

(d) The illustration is like the first but includes a 1/2-point interest bonus in years 16, 21, 26, etc., all calculated retroactive to year 1.

(e) The illustration is like the first but includes a 25% annual premium bonus in years 16 and beyond.

(f) The illustration incorporates all the above enhancements.

The table below summarizes the illustrated cash values on each basis for a level $100,000 death benefit (except for corridors) and an annual premium of $1,200.

Illustration	Illustrated Cash Value	
	Year 20	*Year 30*
Unenhanced	$32,451	$ 69,900
(a)	33,227	74,187
(b)	34,059	81,260
(c)	45,292	118,584
(d)	34,968	107,127
(e)	34,430	80,846
(f)	52,174	171,521

There are, no doubt, many other methods of proposal enhancement not described here. The Microsoft Quickbasic program listing that was used to generate these values will be made available to anyone wishing to contribute additional examples. In any case, here are some questions and comments based on the above examples:

(1) Are some or all of these methods of proposal enhancement inappropriate?

(2) Are they always wrong, or is the problem just the degree to which they are used?

(3) If they are sometimes all right, what criteria should be used to determine when they are all right?

(4) How will the various proposals intended to address these problems deal with each of the examples cited? For example, will cost disclosure proposals eliminate or identify inappropriate enhancements? How should annual statement interrogatories be answered for each of these companies, and what is the intended result of these answers? Will proposed nonforfeiture laws address these examples?

(5) The above illustrations do not differ during the first 15 years of the policy, and they differ by fairly small amounts over 20 years. Using common methods for determining profitability (20-year profit studies discounted heavily by interest and survivorship), any of these illustrations could probably be justified on the basis of expected profits at issue under reasonable and customary assumptions. Of course, the actuary repricing these blocks of business 15 years from now may have a more difficult time justifying the enhanced factors when they are scheduled to actually happen.

(6) There is a proposal that companies not be allowed to illustrate other than their "current" scales unless appropriate "disclosure" is provided. There are two potential problems with this proposal. First, what constitutes a "current" scale? Must a company illustrate a cost-of-insurance rate (or interest rate or expense charge) in year 20 for issue age 45 equal to the rate for a 65-year-old in year 1? Can companies sell different contracts to policyholders in different issue year/age brackets to circumvent these rules? Second, disclosure of these practices would not have a significant effect. How often have consumers actually reviewed, questioned, or made decisions based on the reams of cost disclosure numbers that we currently supply? Most consumers will believe any projection generated by the computer with the apparent blessing of the company, regardless of what the fine print says.

(7) Many companies that use these "enhancement" methods claim that they are all right because they guarantee their enhancements. However, how meaningful are these guarantees? For example, what does it mean to guarantee an interest-rate spread above the then-current rate offered on new contracts? Guaranteeing 50 points higher than another number that itself is not guaranteed is in fact hardly any guarantee at all. In general, unless all the factors in the product have well-defined guarantees, any so-called guaranteed enhancements can probably be offset by changes in other factors.

(8) If long-term guaranteed enhancements are in fact real and substantial guarantees, then should regulators and our nonforfeiture laws allow these extreme "tontine-like" policies to be sold? Clearly, the historical intent of nonforfeiture laws was to require immediate cash surrender values that reflect the value of future guaranteed benefits. Even if these "enhancements" are not guaranteed, should nonforfei-

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