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OPINION

Free lunch?

Maturity extension riders may not be what they seem

by Timothy M. Fitch

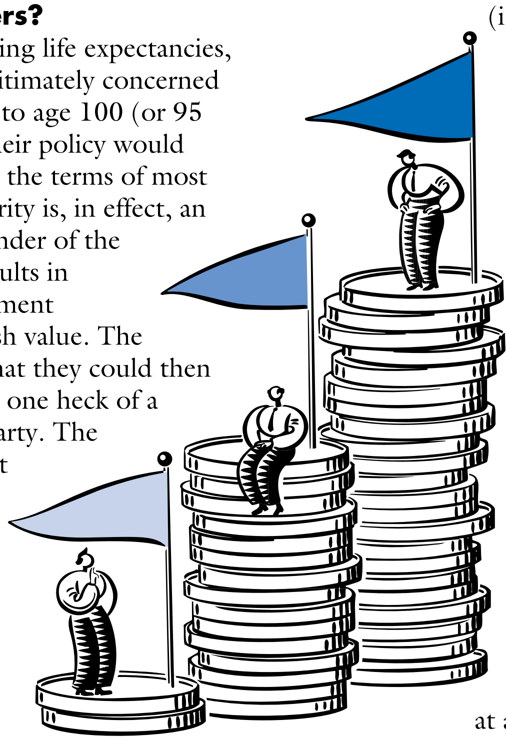
As one who has, for years, enjoyed a healthy debate, I'd like to debate the design of some of the maturity extension riders offered today. I'll take a position and present my case. I invite you to provide your viewpoints — supporting or opposing.

What are maturity extension riders?

With ever-increasing life expectancies, insureds were legitimately concerned that, if they lived to age 100 (or 95 in some cases), their policy would "mature." Under the terms of most contracts, a maturity is, in effect, an involuntary surrender of the contract. This results in an automatic payment of the policy's cash value. The good news was that they could then throw themselves one heck of a 100th birthday party. The bad news was that they would also have to pay income tax on all or part of the payout.

So, maturity extension riders were developed. Simply stated, they kept the contract from maturing. The hope was that this would avert the tax problem by suppressing the involuntary surrender that would otherwise occur at age 100. At the death of the insured, the payment to the beneficiary is an income tax-free death benefit instead of a taxable surrender.

The amount of that death benefit provided by these riders was the cash value at age 100 plus interest to the date of death. If the policy was a traditional whole life policy (or a universal life policy that was funded to "endow" at age 100), the face amount and the cash value at age 100 were the same. In those cases, therefore, the death benefit payable after age 100 was the face amount plus interest. However, if the policy was a universal life policy that was not fully funded (i.e., the cash value at age 100 was less than the face amount), the death benefit payable after age 100 was less than the policy face amount.



So far, so good. But then, as it is wont to do, the world got more confusing. Some companies started offering maturity extension riders that claimed to pay the full face amount upon death — even if there was only $1 of cash value at age 100. In effect, those companies were saying that if you paid for insurance protection until age 100, they would then give you free insurance.

Is there a free lunch after all?

My position

If a company tells a policyholder with a $1 million policy that, should he or she live to age 100, it will pay him or her the $1 million upon death, even if there is only $1 of policy value remaining at age 100, that company must be guilty of at least one of the following:

1. Doing something financially unsound
2. Treating policyholders inequitably
3. Breaking the law
4. Subscribing to the P.T. Barnum philosophy (i.e., there's one born every minute)

Let me take the P.T. Barnum option first. After all the industry has been through, I certainly hope there aren't any companies offering this benefit who are neither guaranteeing it nor planning on living up to their nonguaranteed commitments. For the balance of this debate, I'm going to assume that no company is utilizing this "promise-them-anything" strategy.

So then, how does an insurer provide the "free" $1 million of coverage beyond age 100? There are only two ways I can think of.

Option 1: The first option is that they really don't charge for this coverage and, thus, there is such a thing as a free lunch. Oh sure, I finally find one and I have to wait until I'm 100 to "eat" it. However, if that's true, the company is providing a $1 million death benefit to someone aged 100-plus and not charging them. That, to me, at least borders on being financially unsound.

One could argue, "How many people will really make it to age 100?" Well, I think the number is significant. First, ask Willard Scott — he'll tell you. Second and more seriously, with more companies issuing policies to healthy, insurable people who are already age 80 (or older) and given the many demographic projections that show an explosion in the number of people living to age 100, I think quite a few people will be able to take advantage of the benefits in these extended maturity riders.

But, even if the companies offering these benefits don't agree with me and, instead, believe that there's a very small chance that an insured today will still be around at age 100, there are lots of other risks insurers find it necessary to charge for that have a very small chance of occurring. For example, the chance that a 35-year-old preferred nonsmoking female will die in the year after she was just underwritten is less than three in 10,000. But I don't see too many companies giving $1 million of free coverage to healthy young females — even though there's a very small chance of a death.

So, if the companies aren't charging for the coverage after age 100, I believe they are doing something financially unsound and are guilty of my first charge. And if they are indeed providing a free lunch to one group based on the low chance of a specific risk occuring but not to another, then they're also guilty of my second charge, treating policyholders inequitably.

Option 2: The only other option is that there really is no free lunch. Instead, the companies do charge for this coverage, but they simply make the policyholder "prepay" the charges for this extended coverage before they turn 100. If so, that means that unless the company provides additional cash values to those who have prepaid those charges, the company over-charged everyone who died or surrendered before age 100. That, in my eyes, is inequitable, and those insurers also stand guilty of my second charge.

The only way I can think to structure this benefit on a basis which is both financially sound and equitable is to:

A. Charge for the coverage prior to age 100, and

B. Provide additional cash values to policyholders who have been assessed the charge but not yet gotten the benefit.

Point B is precisely the principle around which the current nonforfeiture laws were built. If someone prepays for a benefit, additional cash values must be given to the policyholder. For example, if a 65-year-old has a $1 million policy that is paid up on a guaranteed basis (because he or she has prepaid the charges for insurance after age 65), the insurer must provide that person a cash value of about $500,000. Similarly, if a 90-year-old has a guaranteed paid-up $1 million policy, he or she must be given a cash value of at least $800,000. By extension, it would seem that anyone age 100 or older who has a $1 million policy which, by terms of the maturity extension rider, is paid up on a guaranteed basis must be entitled to a cash value of at least $800,000. So I would argue that any company that provides paid-up coverage at age 100 and does not provide a cash value of at least $800,000 is guilty of my third charge — breaking the law.

In summary, I will concede that if there is an insurer offering this type of "free lunch" maturity extension rider and if that "free lunch" is contractually guaranteed and if that company provides a cash value of at least $750,000 to all individuals aged 100-plus (even if he or she would otherwise have had only $1 in cash value), it may not be guilty of any of the four charges listed above. However, if that is not the case...

This is where I stand. I invite your response.

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AERF announces Woody scholarship winners

The Actuarial Education and Research Fund (AERF) announced the recipients of its 1997-98 John Culver Wooddy scholarships. They are:

- Jennifer Cardello, Tufts University, Medford, Maine, nominated by Eric T. Quinto
- Jocelyn Norton, Lebanon Valley College, Annville, Penn., nominated by Bryan V. Hearsey
- Matthew Rustige, Maryville University, St. Louis, Mo., nominated by Leonard Asimow
- Raman Srivastava, University of Waterloo, Waterloo, Ontario, nominated by Harry H. Panjer

The $2,000 scholarships were established last year by the estate of John Culver Wooddy, a distinguished actuary who wanted to provide funds for the education of worthy students.

Applications were received from 34 schools in Canada and the United States. The next round of applications will be accepted in June 1998. Undergraduates are eligible if they will be seniors (or the equivalent) by the semester after the scholarship is awarded, rank in the top quartile of their classes, have passed at least one actuarial examination, and are nominated by one of their professors.

Information about the Wooddy scholarships is available from Curtis Huntington, AERF executive director, at his *Directory* address (phone: 313/763-0293; fax: 313/763-0937; e-mail: *chunt@math.lsa.umich.edu*).