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The Ledger Lie

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Many buyers of life insurance now regret replacing their five- or 10-year-old policies with ones that promised 15% but now are crediting only 7%. These policyholders realize today that they would have been better off financially if they had not surrendered their policies and that they were not given the facts when they made the replacement decision. They were victims of "the ledger lie," and in many cases, so were their agents.

One does not have to look far to find examples of the ledger lie. A full-page advertisement in recent industry publications touted a product illustration that could beat the best policy illustration of any company, at any amount, for any type of life insurance. And besides that, the company boasted, it would beat the best commission offered by any other company as well.

An unsuspecting reader would assume that any company with such power must surely be an industry giant. Further investigation, however, reveals that the company which placed that ad had assets of only $178 million in 1987 and total capital and surplus of less than $10 million. In the past five years, it has had operating losses of more than $10 million, including a loss of $900,000 in 1987. Its net yield on assets last year was only 9.17%, and it does not have a rating from any of the rating services.

In light of these facts, how could this company's product beat that of any company, at any amount, any policy, at any age? There lies the catch. The advertisement claimed that the illustration, not the product, could do these things. All that is required to accomplish that objective is a $2,500 computer and a disregard for the interests of the buyer.

In another instance, the vice chairman of one of our industry's better known mutual insurers recently told an agents meeting that companies must go back to their agents and retrain them to sell needs versus illustrations. He was quoted as saying that when they implement a dividend reduction, insurers must make their agents understand that companies cannot pay more in dividends than they are earning. Most dividend illustrations projected by insurers will never be met, he said, and agents who are selling them are subjecting themselves to legal action.

How did this executive arrive at these conclusions? Precisely because, as he himself acknowledged to the audience, his own company had "fallen into the trap" of selling illustrations and was now trying to get out. The company had been crediting 12% to its dividend scale, while earning less than 7.5%. It sustained operating losses of more than $80 million and dramatically reduced a surplus that for more than 100 years had been a hallmark of conservatism.

These examples illustrate a marketing philosophy that I have termed "the ledger lie." The smaller company knows that it is at a distinct disadvantage in attempting to secure market share. It does not have a Best's Rating, is financially weak, sells plain vanilla products and lacks a distribution system. How, then, can it attract business in a highly competitive industry?

The company's response is to create a ledger that appears to be better than any others. It knows that there will be agents who will sell its products and customers who will buy them, even though common sense and sound economics dictate that the policies

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most likely will not even come close to meeting the promises made in the illustrations.

The mutual company in the second example illustrated its products at 12%, knowing full well that its yield had not exceeded 7.5% in recent years. It counted on the fact that many of its agents and policyholders place a great deal of trust in the company's past reputation. The company has been known for its conservatism and history of exceeding dividend projections. Why shouldn't that pattern continue into the future?

Only after $80 million of losses and a significant reduction in surplus did the company finally reduce the interest rate it was illustrating to a more realistic level. But what about the people who bought the 12% illustrations? They will be in for a big surprise when they discover their policies' cash values are accumulating at amounts far lower than expected. The management of this reputable company should have realized that it would not be able to meet the dividend scale it had projected, instead of deceiving trusting buyers by using illustrations that would never materialize.

As more companies attempt to compete by using illustrations or proposals that have little to do with reality, it will become increasingly difficult to identify and select quality companies selling quality products. How can high-quality carriers be selected by a public that often feels intimidated by insurance companies? Certainly, potential policyholders cannot depend solely on illustrations.

CARRIER EVALUATION

A recent study conducted by a group of attorneys affiliated with major brokers developed four criteria to be used in evaluating carriers and their products:

(1) How is the company rated by the major rating services?

(2) How did the company treat its old policyholders in times of interest volatility, particularly in 1982?

(3) How does the company credit interest to its policies?

(4) Are the assumptions used in illustrations realistic?

Let's examine each of these criteria.

(1) *Industry ratings*. There are currently four rating services important to the life insurance industry. They are the A.M. Best Company, Standard & Poor's, Moody's, and Duff & Phelps. A.M. Best, the most widely recognized, has nine rating categories, the highest of which is A+. Only 268 of the 1,475 life insurers rated by Best received an A+ rating in 1988. The experts who conducted the study all agreed they would rarely recommend a life insurance policy that was not issued by one of these A+ rated companies. As a further precaution, these experts said they would limit their selection to those companies that have received the A+ rating for 10 consecutive years. Only 192 companies currently meet that requirement.

CLAIM ANALYSIS

The second major rating service is Standard & Poor's, which evaluates insurance companies on the basis of their claims-paying ability. Standard & Poor's has eight rating categories, the highest of which is AAA. The experts agreed that a AAA or AA rating from Standard & Poor's is a requirement in their selection process.

The third rating service is Moody's, which has 19 categories, ranging from AAA to C. Companies receiving an AAA, AA1, AA2 or AA3 rating from Moody's are deemed to be exceptionally strong. Finally, the newest industry rating service is Duff & Phelps. It has 17 categories of ratings, with 1 being the highest possible rating. Ratings of 2 through 4 are well within acceptable risk limits.

(2) *Treatment of policyholders*. If a purchase is being made for a lifetime, it won't be long before a new buyer is considered an old policyholder. All companies advertise how fairly they treat their old policyholders. The real test, however, comes during periods of volatile interest rates, such as in 1982. At that time, most insurers were crediting between 3% and 7% to their policies. When interest rates shot up to 20%, what did these companies do? Each company adopted one of four philosophies.

A common practice during this time was to continue paying old policyholders the interest rate they were promised originally, even though market rates had gone up dramatically. In some cases, companies paid their old policyholders rates as low as 3%, hoping that they would keep their policies, and thus benefit the insurance company on the interest spread.

A second group of companies permitted their old policyholders to exchange their policies for new policies crediting a higher interest rate. This action had to be initiated by the policyholder, and a new acquisition charge had to be paid at the time of the exchange.

The third philosophy was much like the second, but in this case the conversion was company-initiated. Once again, the policyholder usually had to pay a new acquisition charge.

HONORABLE TREATMENT

The most equitable treatment, however, was performed by those few companies that treated old policyholders the same as new policyholders. These companies upgraded all of their old policies without requiring the agent to sell a new replacement policy.

Companies adopting this last philosophy have two characteristics in common. First, they had to have significant financial new worth to be able financially to upgrade all of their policies. Second, they had to believe that their policyholders were entitled to fairness and equity in all dealings.

(3) *Crediting interest to policies.* There are four basic methods of crediting interest: the portfolio method, the new-money method, the investment cell method and the variable method. A brief look at each will demonstrate how they work.

The portfolio method is exactly what the name implies. The total assets of the life insurance company are aggregated and the yield on the entire block of assets is the yield that should be credited to the policy.

The new-money method credits interest to policyholders based on current interest rates.

The investment cell method matches premium deposits with the interest rate in effect when the deposit is received. In other words, a premium received when interest rates were at 12% would be earning 12%, because that was the prevailing interest rate when that premium was received. Premiums received in future years will earn whatever rate is in effect when the premium deposit is received.

The variable method leaves the choice to the policyholder. With a variable policy, the policyholder can decide whether his or her funds should be invested in stocks, bonds, mortgages, or real estate. The return earned on these investments is credited to the policy, minus a predetermined management fee.

In making a recommendation, the experts stressed, agents must be sure

The buyer must understand that different interest-crediting methods may appear to be more favorable, depending upon the level of interest rates in the economy.

the buyer understands that different interest-crediting methods may appear to be more favorable, depending upon the interest levels in the economy. When interest rates are high, the new-money method products will tend to look more favorable. When interest rates are dropping, the portfolio method usually produces a more favorable projection. Thus, the purchase of a life insurance policy cannot be made solely based on the illustration. A buyer must first ask what method the company is using to credit interest in its illustration.

(4) *Assumptions used in illustrations.* This is determined by identifying the spread between what a company is earning on its portfolio of assets and what it is crediting to its policyholders. In other words, if a company is earning 8% on its assets and promising its policyholders 12%, it soon becomes obvious that this practice cannot continue for very long. Incredibly, it took that previously mentioned mutual company two years and millions of dollars in losses to arrive at that conclusion. A company earning 10% on its *assets* and paying 8% may prove to be a better choice.

The amount of money a company earns on its assets is called net yield. Oftentimes, companies have a low net yield because they have a large number of policy loans on their books that are earning a low interest rate of 5%, 6% or 8%. They may also have a large block of old long-term bonds and mortgages that were purchased during periods of lower interest rates.

On the other hand, an extremely high yield may be the result of an investment policy that may prove to be too aggressive. It may include a large portfolio of unrated junk bonds or hazardous mortgages that could go into default during a recession or depression.

How can a consumer evaluate the assets of these insurance companies, their ability to survive economic uncertainties, and their capacity to meet the long-term promises they are making? That question takes us back to the very first criterion. The experts at A.M. Best, Standard & Poor's, Moody's and Duff & Phelps carefully evaluate all of these factors in arriving at their rating. That's why only a few companies receive top marks from these rating services.

Agents must take the time required to do due diligence on the companies they represent, looking beyond the illustration to the strength and integrity of the issuing carrier. Agents should also require their carriers to secure ratings from the major services, treat their old policyholders fairly and illustrate their products based on reality. They should avoid any carriers that neglect these important business fundamentals.

The agent must then take the time needed to educate the buyer. Many life insurance companies are vulnerable to economic swings. Like banks and savings and loan institutions, they are technically close to insolvency. However, unlike the banking industry, there is little likelihood of a government bailout of insurance companies. Therefore, it is the responsibility of agents to represent carriers who have structured the company and its products to survive the major economic shifts that the next 50 years will certainly bring. □

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