Recent Case Profiles

Articles

Journal of Financial Planning - July 2007

"It is a mystery how index universal life policies, with the mirage of much higher illustrated crediting rates, are in compliance with illustration regulations."

Words of Caution

by Peter Katt, CFP, LIC

My column this month touches on two topics, both of which carry important messages that planners should heed: (1) the return of insurance illustration gimmicks and (2) the dangers of being careless when setting up policies for clients.

Illustration *Liar's Poker*

Misleading life insurance illustrations are back and buyers are again being subjected to policy performance promises that are quite unlikely to be realized. A major type of permanent life insurance is what I refer to as market-priced. Future performance depends on future interest rates, and to a lesser degree future mortality experience. During the late 1980s and 1990s many companies used illustration gimmicks to make their policies appear to have fewer premiums or create higher values than their current pricing could provide. Among the common techniques used: bonus interest in 5 or 10 years, lapse-supported pricing, and return of mortality costs after 10 or 20 years. I never saw one of the gimmicks actually produce better medium- or long-term values versus the practices of companies that didn't resort to such illustration gimmicks. In fact, it is my sense that companies that don't use such tricks produce far superior value for policies.

The illustration wars of the 1980s and 1990s were such a problem that the life insurance industry finally moved to curtail such abuses by promulgating model regulations for life insurance illustrations in 2001. Under the regulations, interest rates embedded in the illustrations are not supposed to be "…greater than the earned interest rate underlying the disciplined current scale." The disciplined current scale requires insurers to use non-guaranteed elements that are "…reasonably based on actual recent historical experience.…"

The new version of illustration liar's poker is index universal life. Index refers to interest crediting rates that are determined by reference to the S&P 500 Index. I have seen illustrated rates as high as 8.2 percent which included a 0.5 percent bonus rate starting in the 11th policy year. The problem is that index premiums collected are not being invested in the S&P 500. One company selling a good deal of index universal life has an investment portfolio containing 96 percent fixed-income instruments. The sellers of index universal life claim they are able to provide such high returns by using various hedging techniques to cover the larger returns. Even if companies actually have designed hedging formulas, such exotic strategies are notoriously inaccurate, the bust of subprime lending practices being the most recent example of how financial wizards are able to outsmart themselves. It is a mystery how index universal life policies, with the mirage of much higher illustrated crediting rates, are in compliance with illustration regulations.

I think it is very likely that index universal life is nothing more than a marketing gimmick used to justify illustrating much higher interest crediting rates than a company's investments can possibly support in order to achieve a competitive advantage. Sales pitches of 10 percent and 11 percent crediting are backed up by such contract language as "…the annual index growth that will be recognized in the calculation of the index earnings for an equity indexed segment on a segment anniversary. We will determine in advance the participation rate applicable to each equity indexed segment for each twelve month period and will communicate it to you in an annual report or in notices to you." Huh? This means the insurance company can credit whatever it wants. Index universal life appears to reawaken illustration wars of the recent past. I see no logical reason why they will provide better actual performance versus conventional market-priced universal and whole life.

The Consequences of Carelessness

Following is a facsimile of an actual case for which I provided testimony. Certain changes have been made for brevity, but the essence of this situation is accurate. I present it as a caution against being negligent, whether out of ignorance or carelessness.

"What has saved you is that none of your clients have died within two years of the life insurance purchase."

A financial planner with little life insurance experience paid a very heavy price because he neglected to exhibit reasonable care in the sale of a term policy having a $500 premium. John and Fred were acquaintances. John offered to do Fred's financial planning. One of the recommendations was to replace Fred's $300,000 term policy with a $1 million 20-year term policy having about the same annual premium, and for his wife Robin to be insured for $250,000 term. Fred agreed and after a brief phone call between them going over the life insurance application, John mailed Fred and Robin a large packet of documents with "sign here" stickers. Included in the documents were life insurance applications for both Fred and Robin. During lunch at their home, Fred and Robin hurriedly signed while taking turns keeping tabs on their one-year-old son. John stopped by and picked the packet up the next day. Fred and his wife had para-medical exams at their home for the life insurance during the next few weeks. A month later the new life insurance policies were issued, premiums paid, and Fred's $300,000 term policy allowed to lapse.

Six weeks after the new term policies were put in force, John and Fred bumped into each other late in the afternoon and decided to have dinner. Dinner and socializing with others continued for several hours and then John and Fred said their farewells in the parking lot before heading home. Within five minutes Fred was dead from a single-car crash just minutes from his home. John spent a good part of the next day at Fred's house consoling Robin and receiving kind words from Robin's father regarding the much larger amount of life insurance recently purchased at John's recommendation. Within days a death claim form was submitted to the life insurance company for Robin to receive the $1 million death benefits.

Insurance companies investigate most life insurance death claims that occur within the two-year contestable period to determine if there have been any material misrepresentations during the application process. Robin's death claim was denied because the application failed to acknowledge that Fred had a DUI and suspended license a year earlier. Robin filed suit against the life insurance company and during this process it was discovered that while the DUI was not disclosed on the application, Fred had answered truthfully about his driving record when this was asked during his para-medical exam. The insurance company had knowledge of the DUI in its underwriting file but failed to make the proper assessment about this life insurance risk that would have taken the DUI into account. Had the DUI been properly handled by the insurance company, Fred would have qualified for the $1 million policy, but with additional premiums for a two-year period. If he had no

additional driving problems for two years, the premium would have been dropped to the intended $500 amount for the rest of the 20-year period. Faced with their failure to properly underwrite Fred's application, the life insurance company settled, but not for the entire $1 million. And Robin was also out the litigation costs. She sued John to recover the balance.

During the trial, it was revealed that John had done a very careless job in processing the life insurance applications. He made three major errors on Fred's application, in addition to not recording the DUI. It is clear that Fred wasn't trying to hide this because he answered it truthfully during the para-medical exam. John didn't even talk to Robin about her application, relying solely on responses given by Fred for Robin.

I testified that it was possible that the planner had missed asking the DUI question as he sped through application questions over the phone. Alternatively, Fred may not have properly understood the DUI question and responded incorrectly. Hurriedly taking the application in this manner isn't the real error John made, however. Whether the application is taken in person or otherwise, before it is signed the agent should always instruct the applicant to carefully read all of the answers to be sure they are complete and accurate. Instead of "sign here" stickers, unsigned applications should have one large sticker instructing applicants to review the questions carefully. In addition, agents should always emphasize that there is a two-year contestable period and if death occurs during this time, the insurance company will investigate for material misrepresentations. This is especially important when another life insurance policy is being replaced that is already beyond the contestable period. There are two statements you never want a beneficiary to hear for the first time following the submission of a death claim: (1) claims will be denied if material representations are made during the application process and (2) your claim is denied.

Robin won her case and recovered the balance of the new policy. In addition, she was awarded damages in the amount of the lapsed $300,000 term policy and then this amount was doubled. She was also awarded attorney fees. The court didn't find John's testimony credible when he claimed that he specifically recalled asking the DUI question. John had a hard time remembering anything about this case, or really much of anything else, except for his perfect recall on the DUI question. He was never contrite. He wore very expensive suits with cuff links the size of golf balls to trial. His demeanor and entire presence really worked against him and I think the damages awarded to Robin reflect this.

John works for a regional brokerage firm. It stood behind him the entire way. Errors and omissions coverage was never mentioned in this case, so I assume John didn't have any. Not having E&O coverage was another huge mistake John made.

John meant to provide good financial planning for Fred and Robin. His sloppiness in the term sale, for which he received commissions of $300, was not intentional. He did, however, pay an enormous price in time, reputation, and money for his ignorance during the application process and his brokerage firm's arrogance during the litigation process. The brokerage firm should have immediately settled the case.

I have no doubt that many financial planners act in a similar haphazard manner when transacting life insurance. Especially when selling term insurance, a favorite of many planners, it may seem a simple matter. What has saved you is that none of your clients have died within two years of the life insurance purchase. John's nightmare should be a warning to be more careful.

Reprinted with permission by the Financial Planning Association, Journal of Financial Planning, Volume 20, Issue 7, July 2007.

Peter Katt, CFP, LIC, sole proprietor of Katt & Co., is a fee-only life insurance adviser located in Kalamazoo, Michigan (269.372.3497).