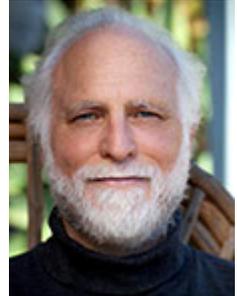


Crashing Through the Insurance Industry's Wall of Silence

By Bob Veres
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Let's say a new client asks you to evaluate her portfolio and make recommendations. The funds and ETFs are easy; you can turn to Morningstar or Lipper and get the performance (for any time period) and yearly expense ratios out to two decimal places. Sales loads and 12(b)-1 costs are right there in black and white.

But when you look at the client's cash-value insurance policy, all of that disclosure goes away. The policy is essentially a mutual fund investment account that pays annual term-insurance premiums on behalf of the policyholder each year, so theoretically you should be able to get the same disclosure on the funds and on yearly payment for life insurance protection, the way you do on any of the term websites.



Bob Veres

Good luck. The insurance company never discloses the sales load paid to the agent, or the expense ratio on the investment account, or even the long-term track record of the company's investment portfolios. The cost of the embedded term – insurance policy is a secret, and few consumers realize that it can be adjusted annually at the company's discretion.

A unique and unusual insurance agent

"We have built an industry that aspires to develop trusting relationships," points out Brian Fechtel of Breadwinner's Insurance in Larchmont, NY. "And yet the first principle of the industry is that we can't provide the disclosure that consumers should have in order to know what they're buying. How many policyholders realize that over the first 20 years of a typical policy, the sales costs amount to twice the total claims and administration costs?"

Fechtel is a rare insurance agent who also happens to have an economics degree from Georgetown University and holds the CFA designation. His approach to evaluating policies is far more analytical than the guy who persistently cold calls your clients about the benefits of equity-indexed annuities. In his spare time, when he's not helping his clients find term and cash-value life coverage, Fechtel is deconstructing the undisclosed internal expenses of the insurance products that are sold in the marketplace.

His goal: to break the insurance industry's century-old code of omerta regarding fees, commissions, policy and insurance costs. Fechtel wants to bring transparency to the buying decisions of cash-value life customers.

How? His analytical process starts with policy illustrations. Whenever you shop for whole, variable or universal life insurance with an agent, you'll be shown a ledger full of numbers, not unlike a spreadsheet, illustrating the annual premiums that the policyholder would pay each year, plus the death benefit and projected cash surrender value of the policy each year into the future. This illustration will be based on a



fully-disclosed assumed annual rate of return, which is often called the crediting rate. Within certain parameters, this entirely-hypothetical investment return can be dialed up or down – a trick which can make some policies look a lot better than others when the agent is sitting down with a prospect at the kitchen table.

Over the years, Fechtel has compared these figures with actual in-force ledgers – that is, with annual disclosures of how the policies have actually performed since they were purchased. As you look over his shoulder, you begin to see why insurance companies are less-than-forthcoming about their product costs and performance.

Decomposing cash-value policies

Fechtel starts by calculating a key number: the "amount at risk" each year in the illustration or the ledger. Whenever an insurer pays a death benefit, it pockets the cash value and remits the face amount to the family. The amount at risk – the amount the insurance company would have to pay out of its reserves (comparable to the face amount on a term policy) – obviously fluctuates year to year as the investment account value bounces around with the markets. (This, incidentally, is why many insurance agents advise their clients to contribute more than the annual premium to their variable policies: what they are actually recommending is that the client systematically reduce the amount at risk and, therefore, the cost of the term premium that will be taken out each year.)

Once he knows the amount that is being insured, year by year, and the rate of return (either actual, from the in-force ledger or hypothetical, from the illustration), Fechtel can look at the growth of the policy's cash value and estimate the expense ratio of the investment account, the sales charges and the yearly cost of the term policy embedded in the contract.

The embedded (undisclosed) term-premium payment, in turn, can be compared with term policies widely available on the market. The expense ratio can be compared with mutual fund expense ratios. Theoretically, a consumer would want a relatively low-cost investment product coupled with a competitive term policy, and at least know the magnitude of the sales load she is paying to the agent.

The results? In a side-by-side comparison of a variety of different policy types offered by a variety of well-known insurance companies (the list includes Allstate, AXA/Equitable, Guardian, John Hancock, Mass Mutual, MetLife, NY Life, Northwestern Mutual, Pacific Life, Penn Mutual, Prudential, SunLife and TIAA-CREF), Fechtel found that the policy costs in year one ranged from eight times the normal term cost to 17 times – much of it due to the front-end commissions paid to the agent.

To get a more precise figure for these sales expenses, you have to be an experienced agent and actually receive these commission checks. Fechtel was a Northwestern Mutual agent for a number of years, and now he shops the market (and its associated commission structures) for his clients. In a whole life policy deconstructed on Fechtel's website, the policyholder pays a \$5,815 initial premium, \$3,722 of which (64%) is paid to the insurance agent. Another \$930 (16%) is paid out as other sales field management costs, and \$466 (8%) is taken out to cover administrative and operating costs.



The agent receives \$696 (12%) of the policyholder's premium payments in each of the following two years, then \$464 a year (8%) for the next three, decreasing to \$232 (4%) over the next four years and \$116 (2%) a year thereafter. Field force fees drop to \$145 a year for years two through eight, although it's not easy to see why the policy should support group sales activities which have already successfully sold a policy to this individual.

What the consumer didn't know is that the agent could just as easily have sold a virtually identical product with significantly lower sales costs. Agents have the option of creating blended policies, which can be thought of as a combination of cash-value plus term (or pure insurance), and most agents can vary the blend to dial their commissions up or down. On his website, Fectel shows two different Northwestern Mutual products; one of them blended, the other traditional. Both have a \$17,750 annual premium for a 40-year-old male in best health. The traditional product immediately deducts first year (primarily sales) costs of \$16,500. The blended product assesses just \$3,000 for exactly the same sales effort.

Are other companies paying their agents comparable commissions? Interestingly, Fectel says that while the life insurance marketplace is highly inefficient to consumers, it is still remarkably efficient with agents. "The compensation structures of the traditional companies are all very similar, aside from little tweaks here and there," he says. What you see here is probably pretty close to the commissions you're paying elsewhere."

Once the agent has been paid for the hard work of selling the policy, the in-force ledger might show something else of interest. In the first couple of years, you find that the cost of insurance closely tracks the term rates that you can readily find on term insurance websites, and of course they increase as the policyholder gets older and a year closer to death. But Fectel found that many of these embedded premiums start to creep up faster than market-based term insurance rates by orders of magnitude. By the time the policyholder in a sample Northwestern Mutual whole-life contract has reached age 59, the cost of insurance – again, calculated from the policy illustration or an in-force ledger – has tripled. By age 59, the owner of a NY Life whole life policy is paying seven times the cost of earlier years.

Meanwhile, the investment accounts would be uncompetitive in the mutual fund marketplace. When he decoded the difference between cash account values and the (rising) term premiums, Fectel discovered eye-opening expense ratios of 2% a year, even though the projections (and, as we'll see in a minute, actual returns) tended to reflect the returns you would get from the average mutual fund. Policyholders are essentially buying closet index funds with a hedge fund's expense ratio.

Many of these numbers are laid out on Fectel's Breadwinner's Insurance [website](#), along with an Illustration Analyzer that any financial advisor or consumer is invited to use. But of course this cost analysis is only part of the story, as Fectel readily acknowledges.

Comparing insurance companies

What's missing? A focus purely on cost leaves out the actual returns that policyholders are receiving from different companies. And it doesn't look at some of the other internal drags on policy performance, such as: Which companies are more efficient in their underwriting, and therefore pay lower claims costs?



Which, as a result of better underwriting, are paying lower rates on the obligations that they outsource in the reinsurance market?

"This is the second leg of my disclosure campaign," says Fechtel. "My original work focused on the disclosure of sales illustrations. Now I'm focusing on how to find an insurer that offers the likelihood of providing good performance with respect to compounding rates and other costs. I've been looking," he says, "at the actual financial data on different product lines of different life insurers."

You can see a detailed picture of two life insurance products in Figure 1, a spreadsheet which dissects various costs plus investment performance on different pools of money, plus the policyholder money the company is allocating to its reserves. "You can see that there are significant differences between the claim costs between the companies," says Fechtel, "and within each company, there will be differences among the different product lines."



Figure 1 – Comparing policies from two companies

	<u>Life Insurer A</u>		<u>Life Insurer B</u>	
	<u>2012</u>	<u>5 Yr Avg or Range</u>	<u>2012</u>	<u>5 Yr Avg or Range</u>
<u>Agent Costs as a Percent of Premium</u>				
first year	59.8%	61.5%	56.3%	56.9%
Truly Single Premium	4.9%	5.0%	3.2%	4.3%
renewals	7.2%	7.3%	9.1%	8.8%
<u>Mortality Claim Costs</u>				
Mortality Claim Costs/\$MM of Net In-force Coverage	1,129	1,237	1,961	2,056
Reinsurance Costs/\$MM Ceded	1,335	1,253	6,043	4,310
Face Amt Ceded and as a % of Total	35%		26%	
Gen'l Home Office Costs/Life Policy	119	109	199	206
<u>Premium Taxes and Misc Costs (as % of Prem.)</u>				
	2.1%		2.3%	
<u>Capital Costs (other than Inv Mgmt Exp (IME))</u>				
Half of Net Surplus Increase As a Percent of Premiums	3.6%	4.2%	-5.9%	0.9%
Half of Net Surplus Increase As BP Charge	24	29	-101	9
ROR on Surplus	7.54%	2.6%	-2.1%	0.7%
<u>Investment Management Performance</u>				
ROR on ALL Mgnd Inv. After IME	5.62%	5.14%	4.78%	5.18%
ROR on Life Reserves Net of Surplus Charge	5.88%	6.26%	8.27%	7.8%
Avg Rate Guaranteed to Life Reserves	4.43%	4.5%	3.43%	3.8%
<u>Other General Financial Data</u>				
Total Inv. Assets	\$64.4 Billion		\$4.6 Billion	
Total Surplus	8.4 billion		850 million	
Surplus/Reserves Ratio aka C/R Ratio	13.7%	12.5% 16.1%	18.4%	18.4% 25.6%
<u>Asset Distribution (Policy Loans Excluded)</u>				
	<u>2012</u>	<u>Range Over 5 Year:</u>	<u>2012</u>	<u>Range Over 5 Yrs</u>
Bonds	72.2%	64% 72.2%	86.8%	79.7% 86.9%
Stocks	2.8%	2.8% 8%	2.8%	2.2% 3.6%
Mortgages	15.4%	15.2% 17.8%	0.0%	0% 0%
Real Estate	0.8%	0.8% 1.3%	0.2%	0.2% 0.3%
Cash	1.5%	1.3% 3.9%	1.0%	0.5% 4.4%
Other	7.2%	6.6% 7.5%	9.2%	9.2% 12.2%
<u>Percent of Reserve Liabilities</u>				
		<u>Comp. Ann. Growth Rate</u>		<u>Comp. Ann. Growth Rate</u>
Individual Life Reserves & Dividends	85%	6.1%	58%	6.9%
Reserves Other Than Indiv. Life	15%	5.3%	42%	7.3%
<u>Policy Related Data</u>				
Total Face Amount InForce		461,641,192		79,602,948
Average Annual Growth of Inforce Over Past 5 Years		5.4%		6.5%
New Sales Over Past 5 Years as a Percent of Inforce		38.4%		53.7%
Cash Value as a Percent of TOTAL InForce		42.5%		57.9%
Cash Value Sales as a Percent of Total New Sales		32.6%		43.4%
Cash-Value Annual Surrender Rate		3.3%		8.9%
Percent of CV Coverage In-force After 20 Yrs		51.0%		15.7%



In Figure 1, for example, you can see that large life insurer A and smaller life insurer B (relative sizes can be seen toward the bottom, under "Other General Financial Data") are paying their agents via similar commission structures, and the return on their investments (and, a few rows lower, on the reserves) are roughly comparable. Company B, however, has significantly higher mortality claims as a percentage of its total coverage (\$2,056 per million of face amount, vs. Company A's \$1,237 per million over the last five years), and you can see that its reinsurance costs per million is two and a half times as high as Company A.

Look down toward the bottom of the spreadsheet, and you are not surprised to see that Company B is taking higher surplus reserves out of the policies than Company A. Add it up and you see that even with similar investment returns, Company A is delivering a more efficient policy than Company B.

This also tells you that the insurance companies have a great deal of discretion in how much they put into their reserves and their own pockets from year to year, product to product. This can work both ways. "My data show that some companies have subsidized their policyholders over a period of years in order to maintain a favorable dividend rate," Fechtel explains. "That helps their sales, but it results in not growing their capital at the same rate of return as their investments."

Of course, sometimes you see the opposite. "One of the age-old criticisms of cash-value life insurance is that the insurance company has the option to profit greatly off of your investment," Fechtel notes. "But you have to look deeply in order to see it happening."

Evaluation from the insurance company's point of view

Companies must make an accounting decision regarding how they allocate costs into different buckets. Because they can vary how much they assess for insurance, and how much they decide to put into their cash reserves and allocate for profits, year-to-year, you can only evaluate an insurance company (and its individual product lines) over the long-term. In this sense, the analysis is not unlike an evaluation of which mutual fund to buy. "In some shorter-term periods, a company could have a favored product and an unfavored product, while this analysis aggregates the company's product lines," says Fechtel. "I tend to think that if one is a long-term policyholder somewhere, one will basically wind up getting the average. They might have favored a particular product in the recent five years, but when it is in the 25th year, it may no longer have management's favor. They might be favoring something else."

After looking at a number of these analyses, Fechtel has seen a few interesting patterns – and also run up against a few additional uncertainties. "Even though I'm no longer working with Northwestern Mutual, I think the data show that they run the basic business of life insurance very very well," he says. "Their reinsurance costs tend to be significantly lower than a lot of their competitors. But you could question whether those costs are lower because they may happen to insure younger people versus, say, Mass Mutual, which has higher reinsurance costs. I can't say for sure," Fechtel admits. "But my hunch is that their average pools of insureds are fairly similar in age composition overall."

It's possible that other companies with high mortality expenses are writing policies on a greater percentage of high-risk insureds – for instance, smokers, firefighters or people who like to go skydiving on vacation, or



simply individuals whose health prognosis is less-than-ideal. "Those data are not perfect," says Fechtel. "But if somebody wants the best available information right now, I think I have it. And I don't try to oversell its usefulness."

Why bother with cash-value policies?

If companies are hiding their cash-value insurance expenses behind sealed doors, then why bother with the product at all? Why not just recommend term insurance, which is a far more transparent contract?

Clients are going to come to you with the policy they purchased some years ago from their joke-telling golfing buddy, asking what you think of it – or they're going to ask you what you think of his latest great deal. According to statistics compiled by the American Council on Life Insurance, individuals purchase between \$400 billion and \$500 billion worth of death benefits through cash-value life policies each year. (see table 7.3 [here](#)) Like it or not, you'll be the person your clients turn to to find out what they've purchased.

The second answer is that some clients will benefit from the tax advantages of cash-value life insurance. "I'm far from anti-term; I recommend a lot of term coverage," says Fechtel. "But when you buy term, you forego the ability to use the insurance expense as part of your cost basis to shield investment earnings." To the extent that the policy has earnings, those premium payments are included in the cost basis whenever money comes back out of the policy. In layperson's terms, it means that ultimately, the cost of the cash-value insurance coverage becomes partially tax-deductible.

More broadly, cash-value policyholders are able to pay for the ongoing cost of insurance coverage with the policy's untaxed appreciation—something that term insurance doesn't offer. "Of course, a cash value policy's costs, when properly measured—not by the simplistic and misleading measure of size of premiums—can be greater than the tax benefits," Fechtel adds. "And it's hard to know if the insurer's investment returns are fair compared with the alternatives."

Thus, there are two goals of Fechtel's exercise in deeper policy analysis. The first is to provide good high-level data for Fechtel's customers to select a company when purchasing a policy, and to evaluate the costs vs. the benefits of cash value life ownership.

The other goal is a bit larger. Fechtel hopes to prod insurance companies into providing full disclosure similar to the way mutual funds do today. "My hope," he says, "is that as this cost and performance information gets into the mainstream, life insurance companies will be forced to show their real numbers, and provide disclosure the way mortgage and mutual fund companies do with their financial products and transactions. I believe if we can ever get to real openness," he adds, "the life insurance industry would enter a golden age. This should be a product that people feel good about buying, and right now I don't think that's usually the case."



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