Policy Pricing Factors Prove Key to Suitability

BY BARRY D. FLAGG

Selecting a life insurance policy that is most suitable for a client's specific goals and objectives can be a complex exercise. While few clients are aware of the intricacies of the cost components among different types of policies and their impact on policy performance, a number of factors point to the need to provide clients with a greater depth of information on the pricing of their life insurance policies.

Indeed, it is generally assumed that the insurance industry will eventually face increasingly stringent disclosure requirements. At the same time, client expectations are changing. More and more clients want to know what their policies really cost based on all of the underlying cost factors and why the pricing structure of a given policy is appropriate to their specific goals.

By performing life insurance product research relative to a client's needs and closely scrutinizing standard illustration assumptions, advisors can bring an added level of value to the client relationship while achieving a distinct competitive advantage.

Broadening the scope

While discussions about the suitability of life insurance policies have traditionally revolved around the type of policy, advisors and their clients would be well served to broaden the focus to include the specific pricing style and structure.

Advisors cannot accurately gauge the suitability of a specific life insurance policy without an understanding of the competitiveness of published pricing over the intended holding period, the stability of such published pricing over the intended holding period, the historical performance of assets underlying policy cash values, the liquidity of policy cash values relative to both the policy objective and peer, group products, and the financial strength of the insurer.

Untangling policy costs

At the outset, it's important to clarify that the premium is not the cost of the policy — just as the $5,000 a client invests in a mutual fund is not the "cost" of the investment. Instead, life insurance policy costs are those amounts deducted from premium payments — often unbeknownst to the policyholder. Even when a policyholder is aware of these costs, it can be difficult to determine whether they are reasonable without separating them into their discrete pricing elements, as follows:

- **Cost of insurance charges (COIs)** — Deductions from permanent life insurance policies to cover anticipated payments by the insurer for death claims. Because the payment of death claims is the principal function of life insurance, COIs typically make up 75 to 90 percent of total policy costs and are the most influential determinant for the suitability of policy pricing.
- **Fixed administrative expenses (FAEs)** — Charges that are set at the time the policy is issued. FAEs can be calculated either as a flat monthly charge or as a percentage of the face amount of the original policy. While these charges are fixed when policies are issued, they can vary from year to year according to a predetermined schedule.
- **Premium loads** — Costs that are based on a percentage of premiums paid in a given year, often ranging as widely as 0 to 35 percent. Premium-based charges customarily cover state premium taxes, federal deferred acquisition cost (DAC) taxes, and sales and service loads/expenses. Premium-based charges also tend to be higher in the early policy years to recover upfront expenses related to underwriting, issue, and distribution.
- **Cash-value-based charges or "wrap fees"** — Fees that are based on policy account values. Just as investment managers charge an investment management fee as a percentage of assets under management, cash-value-based "wrap fees" are insurance fees charged to policyholders as a percent of policy account values. These cash-value-based insurance fees are specific to the policy and typically collected at the policy level, in addition to investment fees. They should be considered in the same way investment fees are when making investment selections.

Only after individual pricing components are divided into these four discrete elements can policy pricing be measured against industry standard mortality tables and industry standard aggregate expenses (see Society of Actuaries at www.soa.org), or by using life insurance policy pricing benchmarking systems. Because life insurance policies are designed with a wide range of pricing parameters, the manner in which costs are constructed and calculated in a given policy is a critical factor in determining its suitability to meet a client's objectives.

For instance, products with low COIs and low FAEs perform optimally in defined-death benefit, minimum-premium situations, even if premium loads and cash-value-based fees are relatively high compared to industry benchmarks. This is because these expenses are calculated as a percent of a minimum premium and minimum cash values, and thus affect performance less than fixed charges like COIs and FAEs.

On the other hand, products with low premium loads and low cash-value-based fees perform optimally in defined contribution, maximum-accumulation situations, even if COIs and FAEs are relatively high. This is because maximizing premiums and cash values has the effect of diluting FAEs and reducing the net amount at risk (the policy death benefit minus the policy cash value on which COIs are calculated), which in turn minimizes COIs.

Optimizing the options

Every aspect of life in the modern age is subject to trends, and the life insurance industry is no exception. The past few decades have been marked by the fluctuating popularity of different types of insurance products, but the lesson is not that universal life is superior to whole life or that variable life is better than universal life. Clearly, no policy type is inherently more suitable than another. The suitability of any policy type is a function of cost factors, the policy objective, the expected duration of coverage, and the investment profile of the policyowner.

For instance, traditional products such as universal life and whole life are typically most suitable for policyowners with a long-term need for death protection or wealth accumulation and a conservative investment profile. Cash values are required by regulation to be invested in predominantly high-grade bonds and government-based mortgages with a historical return of approximately 6 percent. Universal life tends to be most suitable when guarantees are less important and flexibility is needed. Whole life tends to be most suitable when a fixed maximum annual premium is more important than pricing disclosure.

Similarly, nontraditional products such as variable universal life and variable whole life are most suitable for policyowners who also have a long-term need for death protection or wealth accumulation and an investment profile that would call for a more balanced cash value asset allocation and a higher expected policy earnings rate. For instance, moderate-conservative cash value allocations could consist of 60 percent fixed-income and 40 percent equity investments and be expected to earn 7 percent, whereas moderate-aggressive cash value allocations could consist of 20 percent fixed income and 80 percent equity investments and be expected to earn 9 percent.

The availability of sophisticated benchmarking capabilities, along with increasing market pressure to disclose costs and demonstrate suitability, stand to transform the life insurance sales process. Practitioners who are proactive in responding to these industry developments stand to gain the greatest competitive advantage while providing superior service to clients.

Barry D. Flagg, CFP, CLU, ChFC, is founder and president of TheInsuranceAdvisor.com, a leading life insurance product research and rating resource. He can be reached at bflagg@theinsuranceadvisor.com or 813-503-2434.