Large Corporations And Sophisticated Life Insurance Products

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In the continually evolving large corporate marketplace, exploring investment opportunities is a way of life. Survival requires significant returns on those investments. The corporate investment in key executives can be protected by providing employee excess benefit plans. Corporate success requires utilization of tax advantages to the fullest extent possible. It is no surprise that life insurance emerges as a catalyst in the corporate world in pursuance of continued success of large corporations.

Role Of Life Insurance

Life insurance has been utilized both fully and partially to satisfy the needs of many corporations, particularly large ones. Both the corporation and key executives enjoy significant tax advantages when life insurance is properly utilized.

Several insurance products have been designed and developed by a few insurance companies to attract the large corporations. These products are usually designed to provide certain unique advantages to the corporations—high early cash values, low premium, high death benefit, low mortality cost, high crediting rate, or low loadings.

It is not plausible, however, to design one product which provides all these advantages to their fullest extent simultaneously. Some producers, therefore, approach the corporation with several different products from different carriers who emphasize different advantages. Many corporations at this point get confused with life insurance and decide to hire an expert to analyze the products and assist the corporation in understanding and choosing the best product.

As a result, several players with different backgrounds now exist in the large corporate marketplace, and they all hope to satisfy the needs of the corporations by utilizing life insurance. It is vital that these players —the consultants, major producers, major insurance companies, and the corporations—be aware of the finer details of sophisticated life insurance products in order to best serve corporate needs.

Product Analyst

Some consultants are very capable of analyzing the sophisticated life insurance products especially designed for utilization in nonqualified employee benefit plans. There are also many inexperienced people working as consultants. Corporations tend to think that anyone who claims to be a consultant will be knowledgeable. Consultants who were experts in some field other than life insurance, nonqualified benefit plans, or plan administration may believe they are experts in life insurance when they are not. These inexperienced consultants, referred to hereafter as "product analysts," harm the reputations of the capable and talented consultants who do their jobs well.

A questionnaire is usually prepared by the product analyst pertaining to the product and the carrier. The product analyst believes the information gathered by the questionnaire is sufficient to produce a complete analysis, so that a product can be recommended for the client.

But, while the questions generally asked by the analyst are necessary, they are not sufficient to do a complete analysis prior to recommending the right product and carrier. To do a complete analysis/comparison of products, one must go far beyond simply asking the standard questions such as, "What is the current crediting rate and mortality cost?" or comparing the ledgers of different products at a specified crediting rate. Instead, thorough exploration of mortality cost, crediting rate, and loadings is required.

Mortality Cost

The product analyst for the corporation usually does not ask any im-

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portant and relevant questions regarding the current mortality cost. Rather than simply asking for the current mortality cost, he or she should ask for the current mortality cost and the actual mortality experience from each carrier. If the actual experience cannot be accurately ascertained, the analyst should at least determine what percentage of the current mortality cost is comprised of actual mortality experience. Even if the carriers refuse to reveal their actual mortality experience, the product analyst must have enough actuarial background to make a judgment on this very critical issue. The analyst can then inform the corporation of the likelihood and approximate frequency with which one carrier will change its current mortality assumptions relative to another.

Crediting Rate

The usual request from the product analyst is that all carriers submit a proposal at the same (low) crediting rate already chosen by the analyst. This simply does not make sense. It is like asking a Mercedes salesman to show a good Chevy (because another salesman wants to sell a Chevy) so that one can evaluate his or her Mercedes, or vice versa.

First of all, if a carrier offers a higher crediting rate because it can afford to, then it can deliver the proposal and issue the policies with that high crediting rate. However, one should make sure that this particular carrier can really afford the high crediting rate. This is why requesting the prior history of the crediting rate and investment yield rate is critical.

Secondly, even if the product analyst decides that the current crediting rate is overstated, the analyst should not just ask everyone to submit their proposals at the same crediting rate. Instead, the product analyst should find out what each carrier can actually afford, by examining the prior history of the crediting rates and/or investment yield rates, and determine an appropriate crediting rate at which the sales illustrations must also be displayed. This crediting rate cannot be the same for all the carriers under consideration.

The product analyst must also ascertain whether the crediting rate is based on the portfolio method or new money rate. If it is, then the product analyst must explain to the client that although the portfolio method may produce a higher or lower crediting rate than the actual crediting rate for a certain period of time, the method is immaterial over the long term.[1]

The product analyst must also be capable of observing any inconsistency in the difference between the investment yield rates and the net crediting rates of prior years, in order to determine if the crediting rate is unrealistic.

Loadings

Lower loadings could result from various measures taken by the insurance carrier to decrease cost. However, a product analyst must be capable of recognizing whether the loading is lower because of a genuine reduction in cost or whether the reduction is compensated by the current mortality cost higher than the actual experience and/or by the current crediting rate lower than the crediting rate based on actual experience.

The Significance Of Complete Analysis

It is the responsibility of the corporation or the party representing the corporation to make sure a carrier does not make a product look more attractive by playing games with mortality cost,[2] crediting rate, and loadings.

The example in Tables I and II shows how easily a product analyst may end up choosing the worst product, based on the usual information collected, and recommending it as the best.

Table I

Information requested by the Product Analyst	Insurance Products*			
	A	B	C	D
1. Current net crediting rate	10%	10%	8.85%	10%
2. Current mortality cost	$40	$30	$25	$20
3. Loading	15%	15%	15%	15%
4. Coverage	$100,000	$100,000	$100,000	$100,000
5. Premium	$5,000	$5,000	$5,000	$5,000
Information not obtained by the Product Analyst				
	A	B	C	D
6. Net crediting rate based on actual experience	10%	9.5%	9.25%	9%
7. Mortality cost based on actual experience	$40	$40	$40	$40
8. Analyst's assumed crediting rate	8.5%	8.5%	8.5%	8.5%

Based on the information requested by the product analyst (items 1 through 5 of Table I), cash value at the end of the first year is indicated below:

Product	A	B	C	D
1st year cash value	$4631	$4642	$4599	$4653
Rank (based on cash values)	3	2	4	1

*Without any loss of generality, it is assumed that all products in Table I are universal life type products.

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The cash value is calculated by applying the net crediting rate to the amount equal to the premium less the loading and the mortality cost.

Based on the actual mortality cost and the actual net crediting rate (items 3 through 7 of Table I) the cash value at the end of the first year should be as indicated below:

Product	A	B	C	D
1st year cash value	$4631	$4610	$4599	$4589
Rank	1	2	3	4

For Product A, the actual crediting rate and the actual mortality cost (items 6 and 7 of Table I) are the same as the "Current Crediting Rate" and the "Current Mortality Cost" (items 1 and 2 of Table I) used by the analyst. As a result, the cash value of Product A is the same under both sets of assumptions. However, it is worth observing Product C which also provides the same cash value under both sets of assumptions but for an entirely different reason which is called "subsidization."

The carrier representing Product C does not really take any loss during its careful and skillful subsidization. However, the carriers representing B and D do realize a loss in the first year. They will make it up in the future years at the expense of the client if they intend to stay in business and provide appropriate service to the clients.

Now the product analyst asks each carrier to submit illustrations based on a crediting rate of 8.5 percent and, as a result, arrives at the so-called ultimate rank. The results are based on items 2 through 5 and item 8 of Table I:

Product	A	B	C	D
1st year cash value	$4568	$4579	$4584	$4590
Rank	4	3	2	1

Table II indicates that when the right information is not collected, the worst product is chosen as the best (items 1 through 5 versus 3 through 7). Table II further indicates that the analyst's ranks (using items 2 through 5 and item 8 of Table I) are completely reversed when the picture is clarified by information described in items 6 and 7 (net crediting rate based on actual experience and mortality cost based on actual experience) of Table I. The worst product is still chosen as the best when the product analyst sets one crediting rate for all.

Table II

Products	Ranks		
	Based on Information 1-5 of Table I	Based on Actual Information 3-7 of Table I	Based on Information 2-5, 8 of Table I
A	3	1	4
B	2	2	3
C	4	3	2
D	1	4	1

The subsidization between the loadings and the crediting rate is also quite common among several carriers. Tables III and IV demonstrate the subsidization between the loadings and the crediting rate and produce the very same results in terms of cash values and the ranks as Table I produced.

If the product analyst does not obtain the actual information on the products, the corporations will always be fooled by the concept of "one crediting rate for all." If the product analyst requests all the carriers to submit proposals with the same crediting rate, same mortality cost, and same loadings, then all the products will have the same values.

A similar analysis can be performed by calculating the minimum premium necessary when the death benefit and/or cash value is given in a specified year. The analysis also applies when based on cash value at retirement age.

Guide To Successful Evaluation Of The Products

If a product analyst would like to successfully evaluate products and choose the best based on actual information in order to best serve the corporate client, then the product analysis must be based on the following:

(1) History of crediting rate to justify the validity of the current crediting rate.

(2) History of yield of investments to observe any inconsistency in the history of the crediting rate so that one can determine if any potential subsidizing takes place.

(3) Current mortality cost, and

Table III

Information requested by the Product Analyst	Insurance Products			
	A	B	C	D
1. Current net crediting rate	10%	10%	8.85%	10%
2. Current loading	15.0%	14.8%	14.7%	14.6%
3. Current mortality cost	$40	$40	$40	$40
4. Coverage	$100,000	$100,000	$100,000	$100,000
5. Premium	$5,000	$5,000	$5,000	$5,000
Information not obtained by the Product Analyst				
	A	B	C	D
6. Net crediting rate based on actual experience	10%	9.5%	9.25%	9%
7. Loadings based on actual experience	15%	15%	15%	15%
8. Analyst's assumed crediting rate	8.5%	8.5%	8.5%	8.5%

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actual experience if possible.

(4) History of changes in the mortality cost in order to determine if the carrier has a tendency to understate the mortality cost in the early years for competitive reasons with the intention to compensate in the future years, or overstate the mortality cost in order to compensate the unjustifiable reduction in the loadings or policy fee or an unjustifiable increase in the crediting rate.

(5) Current loadings and guaranteed loadings.

(6) The quality of the carrier. For example: reports from Best's and Standard & Poor's, assets, surplus, etc. The analyst should request the financial statements of the carrier for the past five years.

(7) The plan design.

(8) Flexibility of the product (at issue and after issue) in order to satisfy the future needs of the client and to comply with the current tax laws, accounting rules, and future potential tax laws.

(9) Plan administration.

(a) The format of the reports must be consistent with the proposal which was understood by the corporate representative at the time of the sale.

(b) Any changes due to tax laws must be easily implemented in the computer system which administers the plan.

(c) Policy exchanges permitted by the carrier.

(d) Off-anniversary policy values must be provided upon request by the corporation.

(e) Policy reports during administration must help the corporation to determine if the plan will be underfunded or overfunded in the current year and in the future if possible.

Once all the information is received, the product analyst must arrive at an appropriate crediting rate and a mortality cost (or percentage of the current mortality cost) for each carrier independently and obtain sample illustrations based on derived assumptions.

It is vital that the corporation also participate in the product evaluation. Corporate representatives must discuss plan design, accounting rules, and tax implications with the analyst during this period.

Corporations

The corporations must also take the following additional facts into account during the product evaluation.

- The justifiability of the after-tax fee to the product analyst compared to the commission of the agent/broker who may continue plan administration once the plan is put together.
- The time spent by personnel to review and understand the analysis given by the consultant.
- The potential loss of tax deferred interest on cash value (when products with fluctuating interest rates are chosen) when the decision making process takes too long.
- The potential loss of currently available tax advantages due to later changes in the tax laws.
- The potential risk of incorrect analysis and/or recommendations by the product analyst who fails to obtain an overall picture of the situation due to a lack of understanding of tax laws, accounting principles, actuarial assumptions used in the designing of the product, administration, and the corporate needs and priorities.

Insurance Companies

Every participating insurance company must evaluate the consulting firm or product analyst retained by the client in order to determine whether the consultant is capable of the following:

- Understanding the product.
- Understanding the tax laws and accounting rules pertaining to the plan design and the product.
- Explaining the risk and advantages/disadvantages of the product/plan design to the client.
- Evaluating the product based on the needs of the client.

The insurance companies must help the producers who service the clients with plan administration.

In designing the product, the carriers must place strong emphasis on the needs of the clients and justifiable needs of the producers who are capable of servicing the corporate clients.

Conclusion

The example provided in this article illustrates the sort of actuarial games which might be played when choosing an insurance carrier for the corporate client. These games are not all that uncommon in the large corporate marketplace. To avoid them, the players must recognize their mutual responsibilities.

Corporate clients, insurance com-

Table IV

Products	Ranks					
	Based on Information 1-5 of Table III	(Cash) (Value)	Based on Actual Information 3-7 of Table III	(Cash) (Value)	Based on Information 2-5,8 of Table III	(Cash) (Value)
A	3	($4,631)	1	($4,631)	4	($4,568)
B	2	($4,642)	2	($4,610)	3	($4,579)
C	4	($4,599)	3	($4,599)	2	($4,584)
D	1	($4,653)	4	($4,589)	1	($4,590)

panies, major producers, and the consultants/product analysts should all understand the basics of an effective product evaluation. To best serve the corporate client, the guidelines provided here should be followed.J

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(1) Richard W. Vautravers, "Life Insurance and the Impact of Investment Returns," AAII Journal, Nov. 1988, Vol. X, No. 10, p. 19.

(2) Richard W. Vautravers, "Life Insurance Pricing and the Impact of Lapses and Mortality," AAII Journal, Aug. 1988, Vol. X, No. 7, p. 25.