How to Save Money on Life Insurance

Update by the Author

In 1995, the National Insurance Consumer Organization (NICO) became affiliated with the Consumer Federation of America (CFA), the Nation's largest consumer group. NICO is now known as the CFA Insurance Group. CFA's members are state chapters; it does not seek memberships from individuals. Although NICO was started in 1980 with the help of Ralph Nader, whose Foreword begins our 1991 life insurance guide, How To Save Money On Life Insurance, there is no formal relationship between CFA and any of the Nader public interest groups.

While the 1991 Guide is now dated, in most ways it is still highly useful. If the reader gets no farther than the second paragraph on Page 1, for example, and follows the advice to "See page 43," hundreds or thousands of dollars can be saved by dealing with either Ameritas or USAA Life, which write commission-free policies. In what follows, we'll first review the major developments in the business of life insurance in recent years. Thereafter, we'll make reference to changes needed in particular sections. If you're puzzled about anything, call the author at 603-224-2805; evenings are OK.

Major Developments in Life Insurance Since 1991

The early 1990's saw several major company financial failures that were related to investments gone sour. The recovery from this difficult period is now complete. Without diminishing the seriousness of these failures, we have consistently observed that far more money is lost by those who buy cash value life insurance policies only to drop them within a few years after purchase than has ever been lost in the failures of life insurance companies. A 1995 study by CFA estimated such cancellations cost consumers more than $6 billion each year.

More recently, public attention has been drawn to selling malpractices of major insurers, including the two largest, Prudential and Metropolitan. Much of the trouble developed in the late 1980's out of careless selling of "vanish premium" policies of the kind we warned about at page 95. More generally, consumers were sold policies based on high interest rates that couldn't be sustained -- see pages 57-59. Some of these practices were more serious, such as the churning of life insurance policies, that is, the indiscriminate replacement of existing cash value policies to generate commission income for agents. We warned about this at page 75 and elsewhere. There remains significant litigation in life insurance as we enter 2001. The litigation has had a modest impact on life companies, however, many of which have adopted new compliance procedures for agents and brokers. For several years, the National Association of Insurance Commissioners (NAIC) has struggled to draft model rules for life insurance policy illustrations and related sales material that are now effective. Regrettably, the rules, which were essentially written by life insurers themselves, offer little help to consumers and may add to their confusion. *Caveat emptor* is still prudent.

Interest rates that insurers credit to their cash value policies declined significantly in the 1990's. (See pages 58-59.) Interest rates on many universal life (UL) policies are as low as 5%, occasionally lower, and UL policies have lost market share they never merited. Interest rates in whole life (WL) dividend formulas of mutual life insurers ("dividend interest rates"), which exceeded 9% for many such insurers in 1991, have come down into the 7%-8% range for the better performing companies. (A remarkable exception is Northwestern Mutual Life, which in November 1997 increased its dividend interest rate from 8.5% to 8.8% and has continued that latter rate into 2001. NML's performance on behalf of its policyholders exceeds that of any other U. S. life insurer.) During 2000, the Federal Reserve raised interest rates several times, and current interest rates on some UL policies rose, perhaps half as much as the prime rate). The Fed has now decreased interest rates a notch as we write. It is a fool's errand to predict interest rates; nevertheless, our best guess is that WL dividend interest rates will probably drift down a bit in the future, as will current interest rates of UL companies that raised those rates in 2000. In reading the Guide, you'll need to mentally adjust for the decline in interest crediting rates since 1991.

Computer illustrations of WL and UL cash value policies now conform to the rules noted above. They limit some, but not all, of the actuarial manipulations used mainly by UL companies in recent years. Second-to-die policies (page 91) have become a big part of the business since 1991, and manipulated illustrations continue to be used by many companies to lure buyers into low premium contracts that are likely to prove troublesome years hence. Prospective buyers are urged to take advantage of CFA's Rate of Return (ROR) Service, described at page 100 and at the end of these notes, which can detect these manipulations.

With the remarkable rise in the stock market since 1991, variable universal life (VUL, page 66) has gained a major market share despite the NASDAQ "crash" during 2000. Variable annuities have also been popular, despite extraordinarily high costs from most insurers. We comment further on these products below.

Perhaps the most dramatic development in life insurance since 1991 has been the change in the term insurance market. In the first paragraph of the 1991 Guide, we recommended annual renewable term life (ART) as our "basic life insurance recommendation." As explained below, this has proved a wise choice for those who made it, but the explosive growth of "quote services," firms that market term life insurance using 800 telephone numbers or, more recently, the Internet has turned the term market on its head.

The gap in consumer value between WL policies, generally written by mutual companies owned by their policyholders, and UL policies, generally written by stockholder-owned insurers, has widened in recent years. With the exception of the UL policies of Ameritas and USAA (and a handful of others), we urge any readers of this update to avoid UL companies. And, if you want to buy from a local agent, it's hard to make a case for any insurer other than Northwestern Mutual, but read page 46 first.

Finally, in what is the most fundamental change in life insurance of the 20th Century, a number of U.S. and Canadian life insurers have announced plans to change from mutual life insurers to stockholder-owned form. These include giants John Hancock, Metropolitan and Prudential. Policyowners in these companies (Prudential is in process) have received windfalls in the form (usually) of free shares, often of substantial value, in the new organizations. Those owning policies in mutual life insurers that have announced demutualizations must hold their policies at least until the date at which shares are earned (which may be before shares are traded). Based on prior demutualizations, one should elect shares rather than cash and hold the shares for at least a year. (The market for these demutualized insurers during late was about as strong as the NASDAQ was weak, however.) Those owning policies in mutual insurers that have not indicated an intention to "demutualize" are warned of the risk in missing a windfall if they surrender their policies. Certain policies may not be eligible for shares, so contact your life insurer for details.

Additions and Corrections to the 1991 Guide

Foreword We think the record of the industry since 1991 has fully justified the harshly critical tone of Mr. Nader's Foreword, as well as the blunt warnings of the author that are found in subsequent pages. There is one trend that is positive for holders of life insurance policies: the policy termination rates cited in the Foreword (see also the discussion at page 75) have fallen substantially. The best guess is that at current rates of termination at least 50% of cash value policies will last 10 years, up from 20% cited in the 1991 edition. (Reporting of such data lags several years.) The bad news part of this statistic is that since such policies have to be held 20 years or more to become good investments, about half of those who buy cash value policies will have poor investments. Of the 50% who terminate, most will do so in the first three policy years and lose all or virtually all of their investments.

The most important message that we can convey continues to be to watch out when an insurance agent or financial planner asks to see your existing policies. Not one in a hundred knows how properly to evaluate the worth of those policies if they are not simple term life insurance. Use the low cost service described at the end of this update.

Page 1 -- Glenn Daily's book is now out of print. He has subsequently written Life Insurance Sense and Nonsense, available for $12 from him at 234 E. 84th St., NYC 10028, 212-249-9882. Glenn is a fee-only financial planner, whose expertise exceeds any others we know of. You can visit his web site at www.glenndaily.com.

Page 2, Annual Renewable Term Life Insurance (ART) -- On this and succeeding pages, we explained that the basic form of life insurance is annual renewable term life, or ART, in which premiums for pure protection -- no cash build-up -- increase each year as one ages. ART, we said on page 1, "is the simplest form of coverage to understand, has the

lowest current premium rates, allows you to buy plenty of coverage for your family, and doesn't cost an arm and a leg if you decide to drop it." While this remains a true statement, we barely discussed level premium term life, which in recent years has become the mainstay of the quote services and which has produced intense price competition. Level premium term life is, as the name implies, coverage for a period of years -- 5, 10, 15 or 20, even 30 -- during which the premium remains level. Quote service competition has spurred companies to guarantee these rates for the period of coverage, although during 2000 new regulations have limited such guarantees significantly, as can be seen below. Milton Brown, proprietor of Insurance Information Inc. (page 38, and 800-472-5800), from his extensive data base of term rates of all kinds, provides this example of how level term rates have decreased for the most healthy applicants since 1991:

Guaranteed 20-Year Level Premium Term
Male Preferred Nonsmoker 40, $250,000

Year	Premium
1991	$ 605
1992	533
1993	528
1994	453
1995	405
1996	360
1997	275
1998	250
1999	225
January, 2001	250

The new regulations have caused life insurers to back off quoting ever lower guaranteed rates.

Level premium term has had a great deal of publicity in recent years. In conversations with financial reporters, we have consistently stressed these concerns:

(1) Policies with the lowest rates are renewable at the end of the term of coverage at attractive rates for your higher age at that time *only if you remain in excellent health*. Sky-high rates apply if your health has deteriorated. Level premium term is therefore not a complete substitute for ART that is renewable beyond the period of level premium coverage.

(2) If you buy a level premium policy, especially one for 15 years or longer whose premium is considerably higher than ART premiums in the first few years, and rates for level premium term decrease, you've overpaid for coverage relative to ART. Many earlier buyers are now finding they can profitably quit their level premium term policies for new ones or can get more years of coverage for the same or lower premium. Virtually all those who bought level premium term policies prior to 1998, say, made a mistake, as it turned out; they should have bought ART, which would have preserved maximum flexibility to adjust to changing markets.

(3) One needs to take the time value of money into account in comparing level premium term with ART, but many sellers simply add up the premiums for the alternatives. This can be more than a minor point with 20-year or longer terms.

(4) While many level premium term buyers rationalize the term of coverage as all that's needed -- "the children will be gone by then" -- the advent of a major health impairment toward the end of the period of coverage might cause a different outlook on such need when it's too late.

The premium in the table above for 1999 is more than 60% below that for 1991. Only a part of this large decrease is due to mortality improvements; most is due to a division of the single “preferred nonsmoker (PNS)” class into multiple classes, with the lowest rates going to an increasingly healthy clientele that can meet ever more demanding health screening tests. Life insurers have seen that blood-testing, originally a defensive maneuver to combat AIDS, when combined with other tests, has virtually eliminated death claims among the healthiest adults under, say, 50. This is good

news for those who can meet the new underwriting standards for the lowest premium classifications, but not so good news for others. Accordingly, if you're in the market for term life today, be patient if you don't get the best rate right off; try several companies.

Despite the retrospective merit of our recommendations favoring ART, the question now is whether level premium term rates are low enough to make them a reasonable alternative for those who are willing to run the risks noted above. We would give a cautious "yes" to this question. In particular, ten-year term life rates have been mostly unaffected by the new regulations. Our favorite strategy, having been convinced of it by Glenn Daily (www.glenndaily.com), is this: buy Ameritas's ten-year term policy. Rates are nearly as low as the lowest ART policies, and if one's health deteriorates such that renewal for a second ten years at low rates is not possible, one may convert to Ameritas's low-load (no agents' commissions) policies, which are attractive. For young buyers (those under 40, say) who don't smoke, can qualify in the best class, and who need $250,000 or more, the ART rates of Berkshire Life and Northwestern Mutual ART are good choices; they are renewable to age 70 (NML) or indefinitely (Berkshire) regardless of health changes.

Even smokers in good health with the right HDL/LDL ratios and other profiles can qualify for better deals as preferred smokers. The best rates for smokers, however, are far above those for nonsmokers.

Page 15, Paying Premiums -- We failed to warn sufficiently about the costs in some *whole life* companies of paying more frequently than annually. Metropolitan is the most visible flagrant offender; its charge is $9 per $100 (.09 x the annual premium), which is more than a 17% Annual Percentage Rate. Two of our ROR Service clients were paying a 35% APR in MET to pay semi-annually. In such cases, it would be far better to take out a policy loan, pay annually, and repay the loan systematically. Here is a brief table to help you figure out your APR; first divide the premium you are paying monthly, quarterly or semi-annually by the annual premium -- both should be found in the "Specifications Page" at the front of your contract. If your annual premium is $1,140 and your monthly premium is $100, the fraction to enter the table with is $100/$1,140, or .0877, or an APR of 11.3%, as can be determined by interpolation in the table below..

Monthly Payment`		Quarterly Payment		Semi-annual Payment	
Fraction	APR	Fraction	APR	Fraction	APR
.0870	9.5 %	.2575	8.0 %	.5100	8.2 %
.0880	12.1	.2600	10.7	.5150	12.4
.0890	14.6	.2625	13.4	.5200	16.7
.0900	18.6	.2650	17.1	.5300	25.5

A monthly factor of .0875, for example, would be half way between 9.5% and 12.1%, or about 11.0%. Paying premium annually is usually a good investment of one's money since there is no annual income tax on the savings, as there would be if you were paying monthly and had money sitting in a money market account drawing taxable interest at a lower rate. (Technically, if you later surrendered the policy with a taxable gain, the gain would be larger with annual premiums and the savings from paying annually would be tax-deferred rather than tax-free.)

These comments do not in general apply to UL or VUL policies, whose values are not keyed to the annual payment mode. But there may be higher charges if your payments are not made by automatic deductions from your checking account. And, some companies may have a fixed charge, such as $2, that's deducted from each payment. Prudential, for example, deducts $2 from each of its variable life policy payments; one of our rate of return customers was paying PRU just $23/month, and the $2 represented nearly a 10% of premium charge. This sort of relationship should be avoided. Holders of UL or VUL policies may wish to determine if their premiums are credited on the day of receipt or on the next monthly anniversary; if the latter, pay premiums just before the monthly anniversary.

Page 17, Policy Loans -- Variable policy loan rates, averaging about 9.5% in mid-1990, declined in cost, averaging about 7.25% in 1998 and 1999, increasing to about 8% in 2000. Interest rates on policy loans track long-term, corporate bond interest rates on a lagging basis, and they can vary according to the policy anniversary month. The rest of pages 17 and 18 needs to be interpreted with the reduction in interest rates in mind. Northwestern Mutual's "direct recognition" loan shown on page 18, for example, would now have an effective loan rate of 9.5% -- NML's dividend interest rate in 2001 is 8.8%, and its "spread" is .7%.

We failed to say in 1991 that if you own a universal life (UL) policy with a loan, **pay no more premiums until the loan is paid off**. Immediately change premium payments to loan repayments. This will bypass premium loads (percent of premium deductions) that can be as high as 9%, and typically are about 5%. Suppose your premium load is 5%; a premium payment puts 95% of that premium into the account value, while a loan repayment increases the account value by 100% of the amount paid. Even if you have one of the rare UL policies whose premiums are subject to no load (they get you in other ways), it makes more sense to pay off the loan than to pay the premium, unless you have a "wash loan," because you will be paying a spread, sometimes a substantial spread such as 3.5%.

Many UL and variable life policies have "preferred" loans in which the "spread" is reduced from a typical 2% to as low as 0%. Conditions usually apply, such as having to keep your policy in force ten or twenty years. The purpose of such concessions is to enhance the attractiveness of the policy as a retirement planning device; money can be withdrawn from the policy as a no-cost loan free of any income tax implications. There is no net cost because the company credits your borrowed-upon asset the same rate as it charges in loan interest. No-cost, or "wash," loans are viewed by some companies as risky tax dodges, so most companies do not guarantee a 0% "spread". Will these no-cost loans really be free of cost? More likely, the company will lower the then current interest rate on all policies to get its spread. Keep your eye on the "steak," not the "sizzle." Nevertheless, a preferred loan from a reputable company is a "plus."

Page 20, Life Insurance for Women -- Massachusetts no longer requires unisex life insurance rates, and John Hancock's rates for women are no longer lowest. Massachusetts Savings Bank Life Insurance (page 39), for statutory reasons not applicable to other insurers, remains unisex; its rates are very low, however, and can be attractive for younger women, say those under age 40, but older women should shop around.

Page 36, Recommended Term Rates -- Table 13 still provides reasonably good benchmarks in buying ART *if the amount of insurance is $100,000 or less.* For amounts much more than $100,000, nonsmokers should refer to the table below. The older you are and the more you buy, and especially if both are the case, the more sense it makes to try one of the quote services. Smokers, especially if over age 40, say, and buying much more than $100,000, should utilize the quote services. For face amounts of $100,000 or less, USAA is excellent. A quick and excellent source of information about term rates, the best we know of, is www.term4sale.com.

As noted above, Northwestern Mutual Life (NML) has particularly low rates for younger nonsmokers who are free of medical conditions and are buying larger policies. Here is an abbreviated table of its rates that can be used to judge your existing term policy or a new one you're thinking about.

Northwestern Mutual Life Preferred Nonsmoker ART Rates
Multiply by Number of Thousands and Add $110
(Premium increases each year after purchase)

Age	Men	Women	Age	Men	Women	Age	Men	Women
18-30	.36	.22	40	.62	.50	50	1.52	1.23
32	.37	.22	42	.79	.64	52	1.80	1.44
34	.38	.22	44	.95	.79	54	2.16	1.72
36	.40	.24	46	1.11	.93	56	2.62	2.07
38	.50	.36	48	1.30	1.07	58	3.33	2.62

The table above includes ages through 58 to show how premiums increase by age; buyers over, say, age 40 should compare these rates to those found in a quote service. Starting around age 55, NML's rates rise rapidly, in part, we judge, because the policy is convertible (see page 39) through age 68 and renewable to age 70. An excellent alternative to Northwestern Mutual, frequently lower in cost, is Berkshire Life, whose ART we have recommended for more than a decade.

Page 38, Quote Services -- There are quite a few new life insurance agencies marketing term life insurance by 800 number and over the Internet. Insurance Information, Inc. (800-472-5800) and SelectQuote (800-343-1985 or selectquote.com) remain active. The best Internet source is term4sale.com, which includes insurers like Ameritas and USAA that the quote services do not do business with; it does not sell term life but instead will give you names of agents and/or companies. The largest is now Quotesmith (800-556-9393 or quotesmith.com), but we recently noted with

disappointment that it now markets non-term life insurance. We strongly recommend that you avoid buying any kind of life insurance except term life from a quote service. Term life policies can be compared to one another by scanning premium schedules; buying a cash value policy based on its low premium could be a serious mistake.

Page 40, Waiver of Premium -- Prudential has sold huge numbers of variable life insurance policies in recent years, and we have evaluated dozens of them in the rate-of-return service described at page 100. While we don't recommend Prudential's variable policies, those who've already bought them should probably keep them. The waiver of premium rider is another matter: premiums are double or triple normal levels. If you have such a rider, consider terminating it if you remain in good health and either have long-term disability coverage at work or could find a way to pay premiums if you became permanently disabled.

Page 42, Life Insurance as an Investment – There are other sources of low-load life insurance including some stock brokerage firms, notably Charles Schwab. We still prefer USAA or Ameritas, however, and recommend that you compare any illustrations from alternative low-load sources to these two companies. In particular, USAA’s whole life (not universal life) is significantly better than anything likely to be found from other low-load sources.

In the first full paragraph on page 46, note that Ameritas now has a 0% "spread" for loans taken out after the later of age 65 or the 10th policy year, subject to certain other rules.

Page 49, Taxes -- Marginal federal income tax rates were increased to 39.6% in 1993 for high income taxpayers, making the tax advantages of cash value life insurance more attractive for them. On the other hand, capital gains taxes were reduced in 1997, making cash value policies less attractive for those who otherwise would be long term investors in common stocks. Variable life policies whose cash values are substantially in common stocks get no benefit from reductions in capital gains taxes, so in theory the 1997 tax changes made variable life slightly less attractive.

We should have discussed "tax-free transfers," mentioned elsewhere in the guide, in more detail. A policyowner is allowed under Section 1035 of the IRS code to transfer his or her tax status to another policy in the same or a different company subject to certain rules that must be followed carefully. The face amount of a new life insurance policy, for example, must be at least as large as the old. In general, life policy values may be transferred to another life policy or to an annuity, but annuity values may not be transferred to a life policy -- to do so would cause a taxable gain in the annuity to disappear at the death of the insured. Policy values transferred must go from company to company, not through the policyowner's hands. The new company can give instructions, of course. One little known facet of Section 1035 transfers can be very important: a loss in a life policy can be carried over to an annuity, and subsequent annuity earnings will be free of income tax until they exceed the amount of the transferred loss. We talked to a rate-of-return client recently, whose mother's policy, bought when she was in her early 60’s, had a taxable loss of about $30,000 nearly 20 years after purchase. (A taxable loss in a life policy occurs when aggregate premiums paid exceed the surrender value, either because large commission and other acquisition charges consume far more money in the early policy years than is earned on the portion going into cash values or because the policy is issued at an age or in a class -- smoker with medical impairments, for example -- where the costs of death protection are higher than the interest credited to cash values, and especially when both conditions apply.) The policy was no longer needed, it didn't evaluate very well, and his 80-year old mother was in excellent health. Our caller asked if there was any reason the policy shouldn't be surrendered. We pointed out that the $30,000 loss was worth about $10,000 in future tax savings (in a 33% tax bracket) if the surrender value were transferred to an annuity (fixed or variable) and his mother lived long enough for the annuity to earn $30,000, a realistic expectation given her good health.

Page 56, California Rate-of Return Disclosure -- In 1991 no state had adopted rate-of-return disclosure for cash value policies (or any other system of relative cost disclosure consumers might find useful). Since then, California instituted such disclosure by regulation, originally with outdated actuarial assumptions. After the assumptions were corrected and before the disclosure regimen had a chance to catch on, the life insurance companies convinced the California legislature to overturn the legislation. This anti-consumer legislation pleased the life companies, no doubt, but the facts are that in the last ten years or so premiums generated by new sales of cash value life insurance policies have fallen more than 30%, when adjusted for inflation. Keeping buyers in the dark does not seem to be working to help the business enjoy healthy growth.

Page 58, Sales Illustrations -- We commented at the beginning of this update on attempts by insurance commissioners to rein in the excesses of some companies' computer illustrations that are used in most sales of cash value life insurance

policies. The new regulation noted has removed the worst excesses that many marginal insurers engaged in. At the same time, illustrations have become more complex, and they offer no help to consumers seeking to buy life insurance wisely.

At page 59, we commented on Northwestern Mutual Life's (NML's) "dividend interest rate," 10% in 1991. It fell in two steps to 8.5% for 1994-1996, then was raised to 8.8% for 1998-2000, the highest we know of in the business. Ameritas's 8.30% rate in 1991 is now 5.9%, the extent of the decline being typical for UL policies. Ameritas can earn its rate in today's market but Northwestern (and others with dividend interest rates much above 7%) probably can't in the long run. To compare NML to Ameritas, for example, ask NML for an illustration run at an interest rate at least 1% lower than its current rate. Virtually all companies can produce such illustrations.

Page 61, Single Premium Whole Life Policies -- The market for SPWL's is moribund, yet the market for annuities has grown rapidly. Financially speaking, this is illogical, as we explained in 1991. Much of the growth in annuities has come from bank sales, however, and the need for banks to seek at least modest evidence of insurability is one reason for the lack of interest in SPWL's. If you're interested in an SPWL, the best source is Northwestern Mutual (local agents), but make sure it's a true, old-fashioned SPWL. Some agents (not necessarily NML's) will try to sell you an annual premium whole life policy with one payment illustrated under the "vanish" scheme; as a general rule, avoid these.

Page 66, Variable Life Insurance -- Variable life has grown rapidly, helped immeasurably by favorable trends in the securities markets since 1991. Virtually all such contracts are now in the variable universal format (VUL), which offers premium flexibility. The major change for consumers is the advent of a low-load VUL from Ameritas, teaming up with mutual fund managers Vanguard and Neuberger & Berman. If you're interested in a VUL, call Ameritas (800-552-3553). USAA (800-531-8000) more recently added a variable. If another company's VUL is in the picture, ask Ameritas or USAA for an illustration using the same premium outlay and death benefits, if possible. Then compare cash values between the alternatives. Ameritas recently added a second-to-die, or survivorship variable. Low-load variables may not be available in all states, most notably New York.

VUL illustrations can obscure subtle risks of ownership by assuming the same gross rate of earnings, say 10%, for all years illustrated. In practice, of course, returns, especially on common stock separate accounts, will have substantial variability. If earnings are low in the early years, when VUL charges are high relative to premiums paid, the policy will have significantly lower long-run performance than it would under the assumption of a constant rate of earnings, even if at the end of the period chosen for comparison the average annual earnings rate has been the same. With the stock market at historically high levels by all measures, it is worth keeping this anomaly in mind. Sticking to a low-load VUL will minimize its effect.

Even low-load VUL's can be expensive. We recently compared a low-load VUL with 100% in stocks to low cost term life plus a very low-cost, Vanguard stock index fund. The latter combination was better, its lower expenses overcoming the tax-advantages of the VUL. But this assumed each alternative is kept until death without withdrawals of funds for retirement. When substantial withdrawals during retirement, first by partial withdrawals, then by "wash" loans, are added to the picture, the advantages shifted to the VUL. This was because the funds could be withdrawn from the VUL without incurring income taxes (assuming the policy is kept in force until death) whereas capital gains taxes were payable upon liquidations of shares in the mutual fund.

Page 68, Tax Deferred Annuities -- Our advice in 2001 is the same as in 1991: compare any TDA to those offered by USAA Life and Ameritas. A new entrant in this crowded market is the "equity indexed annuity," in which returns are linked to increases in (usually) the S&P 500 common stock index, but with a minimum guarantee of principal, perhaps 90% of your premium accumulated at 3%. This "downside" guarantee combined with the potential for appreciation is alluring, but we suggest you avoid these complex instruments in favor of a low-cost variable annuity, perhaps dividing your money between bonds and stocks in hopes of limiting downside risk.

There is a subset of annuity companies that markets high commission, gimmicky TDA's that we would avoid. Most feature high first year "bonuses" -- we've seen as high as 8%, payable in addition to the regular interest rate -- that due to double-digit surrender charges (both as a percentage of premiums in the early years and for terms of ten years or more) really aren't bonuses. Others offer a higher interest rate but only if you annuitize at retirement, with limited annuitization rate guarantees. TDA buyers should understand that marketers of annuities frequently compete with each other by offering higher commissions to agents (and free junkets if agents reach certain production goals). It should follow that

the higher the commission the lower the interest rate that can be paid, but high, long-lasting surrender charges can help the insurer earn slightly higher rates by investing annuity premiums in somewhat longer term securities and making profits from those who terminate their contracts during the surrender charge period. Life insurers working this market are seldom household names, usually have lower financial ratings, and may take greater financial risks by purchasing longer-term or lower-rated securities. An upward "spike" in interest can make it profitable for annuity owners to transfer their contracts to higher yielding TDA's, even after incurring a surrender charge. If many do this, the insurer may have to raise cash by selling the longer term securities at a loss, thereby weakening its financial strength. The other question about aggressively marketed TDA's, perhaps more important, is whether the insurer will simply lower its rate of interest below the market in years after the first inasmuch as it has the buyer locked in by a large surrender charge. Buyers need to follow these rules: (1) understand the pattern of surrender charges; (2) ask the insurer for its historical record of interest credits and study it to see if any worrisome patterns arise; and, (3) keep any annuity investment, including interest added to it, below the state's guaranty fund limit, usually $100,000.

At page 71 we said that TDA income could be deferred until age 80, but most companies allow distributions to be deferred beyond that age.

Page 72, Variable Annuities -- Sales of variable annuities have been very strong in recent years, thanks to the large rise in the stock market that obscures the enormous fees most insurers charge, averaging about 2.1% of assets each year. In stark contrast, Vanguard's (800-522-5555) variable annuity total asset charges average .68% and can be lower. Recently, Vanguard added a high-yield bond fund to the choices available. Choosing a high yield bond fund for one's variable annuity and buying common stock mutual funds has always made sense to us. There is a certain aspect of tax-deferral in taxable common stock funds (earnings not distributed in dividends or capital gain distributions), and the capital gains tax advantage legislated in 1997 does not apply to gains within variable annuity separate accounts.

A word about the Vanguard family of mutual funds is in order. Vanguard is the only mutual fund operator we know of that is the equivalent of a mutual life insurer. All profits from Vanguard's asset charges are used for the benefit of shareholders of the funds, unlike other mutual funds where profits go to the owners of the mutual fund company. This is why Vanguard's operating expenses are so low. Asset charges in other mutual funds tend to remain at about the same level from year to year, perhaps even rise in popular funds, but in Vanguard they tend to keep decreasing. The author has held a Vanguard high-yield corporate bond fund for fifteen years; in the beginning the asset charge per year was .7% or so; today it is less than .4%. You can buy a Vanguard indexed stock mutual fund for less than 2% per year. Low expenses don't guarantee best performance, of course, but they do mean better than average performance.

In 1999, TIAA/CREF, which operates retirement programs for college and university employees and certain non-profit organizations, opened up some of its products to the general public. Included were variable annuities and mutual funds, which can have slightly lower fees than Vanguard. Call 800-223-1200 for information.

It rarely makes sense to buy variable annuities in qualified retirement plans, such as IRAs or 401(k)s, because these plans already provide tax deferral. Annuity advocates stress other benefits, such as the guaranteed minimum death benefit and guaranteed annuity rates. But the bottom line is that you'll pay an extra layer of fees -- as much as 1.40% of assets each year -- for benefits that are worth only a fraction of that. (One exception: If you're terminally ill and plan to invest in risky funds, such as emerging market funds, a low-cost variable annuity with a guaranteed minimum death benefit might be a good deal for your heirs.)

Page 74, Single Premium Immediate Annuities -- In early 1991, the average monthly income for a male age 65 was about $9.00 per $1,000 of purchase price -- in other words, $100,000 would buy such a person a guaranteed income of $900 per month for as long as he lived. In late 1993, the same purchase price would buy just $730 a month for life. Thirty-year Treasury bonds yielded about 8.25% early in 1991, but had fallen as low as 6% in late 1993. In 1994, the 30-year Treasury bond yield briefly exceeded 8%, and the monthly income per $100,000 purchase rose to $820. In 1998, the Treasury bond fell close to 5%, and the monthly income fell to about $720. Both have risen since then. These examples show how sensitive SPIA rates are to changes in long-term interest rates. SPIA's maximize retirement income by systematically paying out both interest and principal. Call 800-872-6684 or visit annuityshopper.com to get current quotes on immediate annuities. Those interested in annuity income should also consider a variable immediate annuity in which the monthly income is expressed in units and the value of each unit varies from month to month, or from year to year, in accordance with changes in securities markets. Vanguard or TIAA-CREF would be good choices; an alternative would be Fidelity mutual funds, whose fees would be higher but whose performance might be better.

Page 75, Replacements of Existing Policies -- Consumer protections are very weak, and agents can easily make something new sound better than something old, so the advice we gave in this section in 1991 is still prudent. In recent years, replacements of existing whole life or universal life policies with variable life policies have become prevalent, the idea being that you can do better investing your cash values in the stock market. But many existing whole life policies have prospective returns high enough that, when combined with the high fees in variable life, make it quite a gamble to give up the old policies.

Page 91, A. L. Williams -- This agency has now been transformed into Primerica, a subsidiary of Travelers. Have nothing to do with Primerica, its agents or Travelers when buying new life insurance.

Page 91, Second-to-Die Policies -- Ameritas now markets a low-load survivorship policy, including a variable. There is a lot of money to be made selling these policies, and when two lives are combined in one contract, the opportunities for actuarial manipulation are hard-to-resist. A large fraction of such policies is sold on the basis of low, non-guaranteed premiums, since that is something that instinctively attracts buyers. But the lowest premium illustrations rest on optimistic assumptions about future mortality and lapse rates combined with extremely low surrender values. Agents urge buyers not to worry about surrender values, arguing that most buyers are seeking a source of cash to pay estate taxes at the second death and therefore will have no need to cash in the policy. But actuaries producing the low premiums, which are usually not guaranteed, either assume that mortality rates will be lower than average or that a relatively high percentage of buyers will terminate (lapse) their policies. Surrender charges on lapsed policies produce substantial profits that can be used to fund the underpricing that will occur in later years. Most likely, both techniques are used -- it is not possible to tell precisely how these games are being played, and companies playing them don't divulge how they do it. If the optimistic actuarial assumptions don't materialize, we think such companies will lower interest rates in later years or raise cost of insurance rates, or both, to cover the losses that are likely to occur. If this happens, higher premiums will be needed.

Such aggressive illustrations produce the anomaly that a commission-paying company can illustrate lower, but non-guaranteed, premiums than would Ameritas, which pays no commissions. We think it a mistake to be lured into low premium illustrations. Many buyers, understandably, want to minimize the premium burden of a second-to-die policy, but it would be a good deal more prudent to think of the purchase as a tax-sheltered investment and to pay more in the early years, both to minimize the risks of lower interest rates in the future and to maximize the tax advantages.

Currently, several insurers offer guaranteed, low premium contracts that extend assured coverage for a given premium to age 100 of the younger insured person. Conditions may attach to such a guarantee, and huge losses will occur if the policy is ever surrendered. Furthermore, the Bush administration is pledged to eliminate estate taxes, which could make surrender later on a greater likelihood. Nonetheless, such a guarantee is obviously worth thinking about, one major reason being that it is a hedge against extremely low interest rates in the future, as in Japan over the last decade. The real risk is that if one of the two insured persons lives past age 100 of the younger, not a rare event these days, the death benefit can virtually disappears after age 100 if the policy has been underfunded.

In the last sentence on page 91, which is in parentheses, we should have said that investment earnings on trust proceeds are taxable to beneficiaries of the trust.

Page 95, Vanishing Premium Illustrations -- At the beginning of this update, we noted that the sale of "vanishing premium" policies in the late 1980's when interest rates were high had triggered much of the public's disaffection with the life insurance business. The complexities of life insurance make it virtually impossible for consumers to determine if a particular policy is good or bad, but when they were told in the late 1980's that the whole life policies they bought would be "paid-up" in, say, eight years only to find later that at least four more years of payments would be needed, they understood that they had been misled. What happened is rather simple: illustrations showing that the "policy would pay for itself" after so many years assumed that the high interest rates of the 1980's would continue indefinitely; when they did not, it was only a matter of time before the effects became manifest. Had sales illustrations been completely forthcoming in the late 1980's they might have added a warning something like this:

> This illustration assumes that our "dividend interest rate," the interest rate in our dividend scale, currently 10%, will continue indefinitely. You should know that during the early 1980's interest rates were the highest in the history of the U.S. You should also know that interest rates have been falling for the last three years, that we

> decreased the dividend interest rate from 11% to 10% during this time, and that we currently can't earn 10% on our new investments. The meaning of this is that the only way this illustration will prove accurate is if interest rates we earn on new investments rise to more than 10% and stay there throughout your lifetime. For further perspective, during the last 20 years our dividend interest rate averaged 6%; the average for the last 40 years was 5%. Finally, as a rule of thumb, add two more payments for each 1% decrease in our dividend interest rate. Thus, for example, if you feel that returns on investment grade corporate bonds will average 7% during your lifetime, add six more payments to the number shown in this illustration.

This type of disclosure, if not buried in fine print, would have insulated life insurers from all the vanish premium litigation and at least some of the bad publicity of recent years. Even today, nothing like this explanation is provided, although most insurers now show the effect on "vanish premium" illustrations of a lower dividend interest rate.

In the last two years we have evaluated hundreds of policies sold on the vanish premium basis. In the vast majority of cases, we have given our correspondents something like this message:

> The policy you own is well worth keeping, having high prospective investment returns. It is, in fact, a lot better than when you bought it, despite your disappointment in having to pay more premiums. This is because you have paid all or virtually all of the huge up-front charges and are now left with a very good, high-yielding investment, especially when the tax advantages and safety of principal are factored in. Ask yourself whether it makes sense at this stage to have premiums, required by contract for life, taken out of the "tax shelter" inside of the policy if, instead, such premiums could be paid in cash out of resources that currently generate taxable income, such as CD's, money market funds and so forth.

Frequently, we add that the actuarial design of a vanish premium policy is such as to give back in policy years 11-20, say, some of the high charges of the first ten years, making the policy extremely valuable prospectively. This comment, by the way, applies particularly to New York Life's in-force policies, of which we have seen dozens. New York Life is currently crediting about 7.5% in its dividend formula, and that is approximately what the payment of a premium in cash will earn (or the withdrawal of funds from the policy to pay the premium will give up). That rate is free of current tax and tax-free under current law if the policy is held (a) until death and/or (b) until the policy develops a taxable gain on surrender. In short, once you've held a whole life policy in a quality (usually mutual) insurer for five years or so, it is often worth looking at it as one of your better investment opportunities, safety of principal considered especially. Indeed, such policies are often better investments than tax-free bond funds, which in addition to lower yields can fall in value if interest rates rise.

Page 99, Guaranty Funds -- All states now have a guaranty fund.

Page 100, Rate of Return Service -- Since 1991, we have reviewed more than 4000 illustrations in our service, now provided under the auspices of the Consumer Federation of America. (Call 202-387-0087 to leave your name and address or fax number for instructions. Or visit CFA's web site at www.consumerfed.com.) The nomenclature has changed a bit; for existing polices you want analyzed, it is probably better to ask for a "current illustration" rather than an "in-force ledger statement." Fees are now $50 for the first illustration and $35 for each additional illustration sent at the same time; second-to-die policies are $75 for the first, $35 for each additional. Orders should be sent directly to James H. Hunt, 8 Tahanto Street, Concord, NH, 03301-3835. Call 603-224-2805 or send an e-mail to jameshhunt@cs.com with any questions. Make checks payable to CFA Insurance Group.

James H. Hunt, F.S.A.
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