The world's most dangerous insurance publication℠

SCHIFF'S INSURANCE OBSERVER

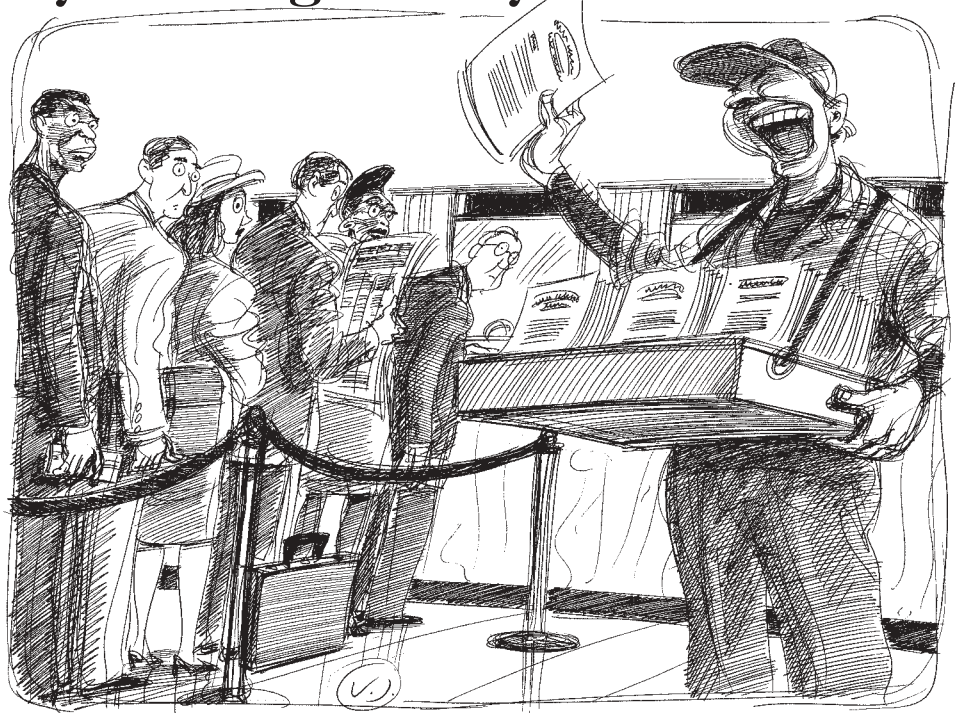
February 15, 2005
Volume 17 • Numbers 1 & 2

Making Money by Losing Policyholders

Lapse-Supported Pricing

Buying insurance is inherently complicated, and it is often in insurance companies' interest to make it even more complicated. "Lapse-supported pricing" is a complex insurance-company practice that is used to create policies whose low premiums are realized because people let their policies lapse instead of keeping them in force. At first glance, lapse-supported pricing seems counter-intuitive. One might suppose that insurance companies would be better off if their customers wanted to renew their policies rather than cancel them. In general, that supposition is correct. When policies are lapse-supported, however, an insurance company is better off if its policyholders let their policies lapse.

The following articles were written by Glenn Daily, a fee-only insurance consultant in New York who specializes in life insurance and annuities. We no longer recall how or when we met Glenn, but we do know that we have thought highly of him for a good number of years. Some of you may have met Glenn at our conferences (he was a speaker in 2002). Anyway, if you aren't familiar with him and his work, you ought to be. Glenn can be reached at 212-426-6265 or gdaily@glenndaily.com. He also maintains a particularly interesting website: www.glenndaily.com.



"Thirty-year level-premium term! Long-term care! Disability insurance!"

Unexpected Rate Rises Jolt Elders Insured for Long-Term Care" stated *The Wall Street Journal's* front page on June 22, 2000. The article that followed described the predicament of senior citizens who had bought long-term care insurance from Conseco and Penn Treaty. They felt betrayed because they had been led to believe that their premiums would remain the same for life, but, in fact, premiums had increased so much that they were left with no good options—they couldn't afford the higher premiums and couldn't replace their coverage because they were no longer insurable. If they dropped their policies they would lose everything they had spent, but the premiums had got so high that they couldn't come up with enough money to keep the policies. They had bought long-term care insurance for peace of mind and had ended up in a financial mess.

The article briefly touched upon a reason why the insurance companies had increased the rates so much (even though they had implied that premiums would always remain level): "The two insurers, which made big pushes into this business and quickly grabbed big chunks of it, deny intentionally underpricing policies to gain market share. They blame their own miscalculations. A key one was assuming that a substantial number of policyholders would change their minds and *let their coverage lapse* early on, thus ceasing to be a liability. Instead, 85% to 95% of customers renewed every year, creating an aging

TABLE OF CONTENTS

clientele that cost far more in claims than expected." [Emphasis added.]

The companies' "miscalculations" demonstrate the risks of what's known as "lapse-supported pricing." Lapse-supported pricing creates serious risks for insurance buyers because it is extremely difficult—if not impossible—for them to assess the suitability and merits of lapse-supported policies. (If lapse-supported policies contain guaranteed premiums, the mispricing risks are still serious, but they are borne by the insurance company.)

All long-term-care policies, for example, are lapse-supported. Three features of this coverage create the risk that premiums will increase even if an insurance company can predict future healthcare costs accurately: (1) The policies are written with a so-called "level premium" based on the issue age. (2) The level premium isn't guaranteed; the company has the right to raise rates for all policyholders as a group. (3) Policyholders who drop their policies in the earlier years get back much less than their "share" of the total premiums paid. In effect, they subsidize policyholders who keep their policies. But the policyholders who keep their policies will get a good deal *only* if a sufficient number of policyholders drop their policies in the early years. This creates a variation of the "prisoner's dilemma." Policyholders who drop their policies early get a bad deal. Therefore, all policyholders should be disinclined to drop their policies. However, if too few policyholders drop their policies, the insurance company may need to raise premiums for *all* (since the level premiums were based on the belief that a sufficient number of policyholders would drop their polices in the earlier years).

Level premiums are designed to make insurance affordable for life. Insureds pay more than the expected cost of claims during their policies' early years, and the insurance company builds up an internal fund that's supposed to cover the higher cost of claims during the policies' later years. Policyholders who drop their policies forfeit their "share" of the insurance company's internal fund. The company expects that some people will let their policies lapse each year, and takes this into account when determining the level premium for all policyholders. The money forfeited by people who drop their policies allows the insurance company to charge lower premiums than it would if it paid the terminators their share of the internal fund. If fewer people let their policies lapse than the company expects, it can raise the premiums for those who remain.

This pricing scheme isn't unique to long-term-care insurance. Many insurers rely on anticipated lapses to achieve profitability for other types of policies including (1) guaranteed renewable, level-premium disability-income insurance; (2) nonguaranteed level-premium term insurance; (3) cash-value life insurance with artificially low cash values in the early years and artificially low costs in the later years.

The following is a profit projection for a group of 30-year level-premium term-insurance policies that was presented by Mark Mahony, marketing actuary at Transamerica Reinsurance, at a Society of Actuaries meeting in October 1998:

Present Value of Profits	30-Year Term Insurance
With assumed lapse rates[1]	$ 103,000
With no lapses	($942,000)

[1] Assumed lapse rates: 12-15% in the first year declining to 5-8% over time.

In this example, the company will make $103,000 if people let their policies lapse at the rate expected by the company. If no one lets his policy lapse, the company will lose $942,000. Since the ultimate lapse rate will become known only over a fairly long time, the losses that may be incurred by the company will become the responsibility of a future generation of managers, who will then decide if the company should raise rates to ameliorate the losses. Higher rates might reduce losses in two ways: (1) they would generate more revenues and, (2) if rates became so high that policyholders find the coverage unaffordable, they may let their policies lapse.

Risks of Lapse-Supported Policies

One should be concerned if companies use lapse-supported pricing because this creates risks, and no one can make an informed purchase decision without understanding these risks.

Let's start with comments made by a Northwestern Mutual actuary at a May 1991 Society of Actuaries meeting:

> When I first learned of these practices, I made a presentation to my boss to explain what lapse-supported pricing was. At the end of my presentation my boss looked at me and said, "Well? What are the actuaries going to do about this?" It was totally natural, in his mind, that the actuaries—who have the control—would devise the solution.
>
> And I had to tell him, "I'm not sure the actuaries are going to do anything about it because, frankly, the people who are coming up with these schemes are probably getting big raises and nice promotions, and they don't have much incentive to scale back." If sales are made based on the assumption that only ten percent will be long-term persisters, the inevitable result is that ninety percent will be disappointed because they had intended to be part of the ten percent.
>
> A car salesman couldn't advertise a picture of a Lamborghini, and put it in a box, and then have customers come in and pay for the Lamborghini, only to realize later that only one out of ten buyers really got a Lamborghini, the other nine getting an old Nash or Volkswagen. He would have to disclose that it's a lottery, and that if you are unlucky, you get the Nash. You have to be lucky and a survivor to get the Lamborghini

Here are problems with lapse-supported policies.

• People who get out early—for whatever reason—will be sorry they bought the policy because they will have overpaid for the coverage they got. Everyone who buys a lapse-supported policy expects to keep it for a long time, but insurance companies know better. Their actual experience confirms that people drop their policies often. Maybe they find a better-looking policy; maybe they suffer a financial setback and can't afford to pay premiums anymore; maybe their insurance needs change. Whatever the reason, some people who were confident that they would keep the policy change their minds later.

• If fewer people drop out than the company expected, there won't be enough money to maintain the low premiums for those who remain. The company has to make an assumption about lapse rates to price the policy, and that assumption may turn out to be wrong. With most policies, lower lapse rates can result in better values, because the company can spread its costs among more policies remaining on the books. With lapse-supported policies, however, lower lapse rates hurt long-term performance. If premiums are not guaranteed, the company's executives can respond to the increasing losses by raising premiums.

• Lapse-supported pricing can put all of a company's policyholders at risk, not just those who bought the lapse-supported policies. If the company sells a significant number of guaranteed-premium

lapse-supported policies that turn out to lapse at a much lower rate than projected, its financial condition could be seriously affected. It might then take money from other policyholders to make up for the losses on the lapse-supported policies. At the extreme, the company might be taken over by state regulators, and the guaranteed premiums on the lapse-supported policies might not be honored.

• The growth of secondary markets in which life-insurance policies can be bought and sold will make it harder than ever for companies to predict lapse rates. Policies that used to lapse may stay on the books and merely change hands. Owners of lapse-supported policies may be able to sell their policies for considerably more than their cash value, but these sales would increase the pricing risk for the remaining policyholders.

• The company may spend the internal fund instead of keeping it for the benefit of the loyal policyholders. Some insurers use the early profits from lapses to pay dividends to their corporate parents, leaving the insurer in a diminished position to pay the attractive values that it *illustrated* to unsuspecting buyers. At worst, this can turn into a Ponzi scheme in which the company has to sell more and more lapse-supported policies to generate funds to cover the losses on the policies that were sold earlier.

• Lapse-supported pricing makes it more difficult for outsiders to determine the quality of a company's earnings. Stock-option laden executives may be inclined to sell lapse-supported policies to create "earnings" that may turn out to be illusory.

• Years from now, the company may decide not to redistribute the money that it has held back. Today's management may be committed to paying everything that has been illustrated, but future executives may not, especially if their compensation goes up if they renege on the implicit contract with policyholders that the company made years before. Or what if another company takes over the lapse-supported policies through a merger, acquisition, or assumption of a block of business? Will it be as committed to fair treatment as the issuing company?

• Lapse-supported pricing can create a perverse relationship between the company and its customers, because at some point the company may be better off if all of its policyholders drop their policies. This is hardly an incentive to treat policyholders well over the long run. The insurer-customer relationship is perverse in another way: the insurer knows its past, present, and projected lapse rates and controls pricing, but the customer bears the lapse risk.

• Lapse-supported policies can lead people to ignore other policies that offer genuinely superior value, because they don't understand that the lower *illustrated* price of a lapse-supported policy may not materialize. Consumers' inability to distinguish high-quality from low-quality policies creates an opportunity for unfair competition. Insurers with competitive advantages in distribution costs, investment performance, underwriting skill, and other fundamentals may lose sales to insurers whose only "competitive advantage" is a greater willingness to rob one policyholder to pay another.

• Lapse-supported pricing makes it difficult for policyholders to decide whether to keep or replace an existing policy because the range of plausible future outcomes is enormous. If a non-lapse-supported policy is poor value, it's likely to remain a poor value and can be replaced. What can you say if a lapse-supported policy is a poor value in the near term but *might* be a good deal down the road? How do you make a judgment about the chances of long-term success, and is that the sort of thing a policyholder should speculate on? Generally, insurance is bought for certainty, not for the speculative chance of hitting it big.

In sum, lapse-supported pricing greatly increases the difficulty of making informed decisions because the risks aren't disclosed satisfactorily and the procedures to ensure accountability are inadequate. It's one thing to make a calculated bet, but most policyholders aren't doing that. It's safe to say that not even one in a hundred insurance buyers understands the risks involved in buying nonguaranteed, lapse-supported policies. They may not think of themselves as speculators, but they're making a speculative investment on lapse rates and the pricing decisions of future insurance-company executives.

A Life-Insurance Example

A client asked for a second opinion on a proposal that she had received from a financial planner (a.k.a. insurance agent) for a $1,000,000 life-insurance policy. Here are the *illustrated* level premiums for the agent's policy and a low-load policy to endow at age 100:

Endowment Level Premium[a]	
Agent's policy	$27,460
Low-load policy	$34,490

[a] $1,000,000 policy issued to 73-year-old woman

The agent's policy pays a full commission; the low-load policy has much lower sales costs because it is sold directly to the public without agents. These sales expenses are reflected in both policies' first-year cash surrender values. The agent's policy has no first-year cash value (all of the premium is spent on commissions and other marketing costs); the low-load policy has a first-year cash value of $29,350. There's no question that the agent's policy has a significant disadvantage in selling expense, which is one of the fundamental factors that determines a policy's cost. So why is the agent's policy $7,030 (about twenty percent) cheaper than the low-load policy?

One reason is that the agent's policy has a super-preferred underwriting class, which the client qualified for. (The low-

Airline Overbooking Compared to Insurance-Company Practices

	Airlines	Insurance Companies
Practice	Airlines sell tickets for more seats than are available on the flight. They expect that some people won't show up.	Insurance companies sell policies with benefits that they cannot afford to pay to everyone. They expect that some people will drop their policies.
Do people understand?	Yes. Most people know that airlines overbook.	No. Few people understand how insurance products are priced.
What happens if it doesn't work as planned?	The airline asks for volunteers to take a later flight and gives them a voucher worth hundreds of dollars.	The insurance company points to the fine print in the contract and says that the policy will lapse if the higher premium isn't paid.

load company doesn't distinguish between preferred and super-preferred). A reasonable estimate based upon the expected present value of death claims is that this difference in policy design might offset the higher selling costs, and then some. (To put it another way, most of the savings created by the client's good health is squandered on marketing costs.) A generous estimate is that this could account for about $1,700 of the lower price.

So why is the agent's policy $7,030 cheaper than the low-load policy? Let's look at the load structure of both policies for clues. We know that the account value at the end of each year is equal to the account value at the beginning of the year, plus premiums, minus loads, plus interest. If the low-load policy requires a $7,300 higher annual premium to grow to $1,000,000 at age 100 than the agent's policy, it would seem that this is because higher loads are being deducted or lower interest rates are being credited.

The low-load policy has no surrender charge; the agent's policy has a $47,750 surrender charge in the first year which declines to zero over twenty years. The surrender charge is paid only by people who drop their policies, so that doesn't explain why it takes an additional $7,030 premium each year for the low-load policy to reach $1,000,000 million at age 100.

The low-load policy has a 3.5% premium load to cover state and federal premium sales taxes; the agent-sold policy has no premium load. Of course, both companies are subject to the same taxes; they're just charging for them in different ways.

The agent's company charges a little more for policy administration ($6 a month versus $4 a month). The low-load policy pays a 0.25% higher interest rate during the first nine years. The agent's company increases the base interest rate by a nonguaranteed 0.25% in Year 10 (so it catches up with the low-load company's rate) and another nonguaranteed 0.25% in Year 20 (so it exceeds the low-load company's rate for the remaining eight years until age 100).

Taken together, these items don't come close to explaining the twenty percent difference in premiums.

There is one item left to consider: the cost-of-insurance (COI) charges that are deducted each month. These charges are typically expressed as a rate per $1,000 of insurance. Take a look at the table below, and then I'll explain what we can learn from it.

Column A shows the current (nonguaranteed) annual rate charged per $1,000 of net amount at risk—that is, the difference between the $1,000,000 death benefit and the account value—for the agent's policy. If the average account value (the sum of premiums received and interest credited under the policy minus partial surrenders, fee charges, and monthly deductions) in the first year is about $22,000 in the first year, the cost-of-insurance deductions would total about $13,500 [(1000 - 22) x 13.83]. The cost-of-insurance rates are roughly level for the first 20 years (similar to 20-year level-premium term insurance), and then they increase each year (similar to annual renewable term insurance).

Column B shows how these cost-of-insurance rates compare with mortality rates taken from the 1975-1980 Unismoker Select & Ultimate Table. That table is based on the actual death-claims experience of a large group of insurers and is often used as a benchmark by pricing actuaries. The mortality rates were measured from 1975 to 1980. Life expectancy has increased since then, so actuaries use a percentage of the 1975-1980 table rates and make adjustments for company-specific factors. A typical pricing assumption for super-preferred underwriting is that the probability of death—and therefore the cost of death claims per $1,000 at risk—will be about thirty percent of the 1975-1980 table.

The cost-of-insurance rates for the agent's policy are much greater than expected death rates during the early years. One reason is that the company uses the monthly cost-of-insurance charges to recoup commissions and other expenses in addition to the cost of death claims. That explains the high charge in the first year and perhaps the second, but the company isn't incurring over $13,000 of expenses in each of the subsequent years. What is the company doing with the rest of the money that it "deducts" from the policy? ($27,460 premium - $13,500 COI = $13,960.)

Column B shows that the cost-of-insurance rates gradually decline to only ten percent of the 1975-1980 table in Year 20. This is just a fraction of the expected cost of death claims. How is the company covering its costs at that point?

After Year 20, the cost-of-insurance rates are in line with expected death claims, with just a small margin for expenses and profit. There is disagreement among actuaries about whether it's reasonable to assume that super-preferred mortality rates will be consistently lower than standard rates throughout life; it's possible that super-preferred and standard rates will converge at advanced ages.

The agent's company (MassMutual in this instance), has a separate division that sells low-load policies to large corporations and wealthy individuals. These sophisticated buyers often put multi-million-dollar premiums into these Corporate-Owned Life Insurance (COLI) policies. Column C shows the cost-of-insurance rates for several of the COLI products. These rates are for the best underwriting class: nonsmoker (there is no super-preferred).

Unlike the "retail" cost-of-insurance rates, the COLI cost-of-insurance rates increase each year, similar to those of annual renewable term. The rates are about fifty-five percent of the 1975-1980 table for the first ten years and, with minor exceptions, gradually rise to seventy-five percent of the 1975-1980 table at the highest ages. Based upon the figures in the table above, it appears that the company's retail division and its COLI division have a significant disagreement about the probability of death for nonagenarians. For policyholders who reach the age of 92, the COLI division charges over six times as much as the retail division; at ages 93 to 98 it charges over twice as much. These differences cannot be explained by the dif-

Comparison of Current Annual Cost-of-Insurance (COI) Rates

		(A)	(B)	(C)	(D)
		Agent's company[1,2]			Low-load company[3]
Policy year	Age	COI	% of 1975-80 Table	(COLI) COI	COI
1	73	13.83	287%	2.68	5.83
2	74	15.37	222%	3.83	7.87
3	75	15.37	167%	5.09	10.04
5	77	15.37	108%	7.91	14.69
10	82	15.39	44%	19.50	25.40
15	87	15.39	16%	39.32	46.37
20	92	15.39	10%	100.35	117.21
21	93	54.16	32%	120.30	126.83
25	97	71.75	32%	168.77	168.63
26	98	76.44	32%	181.39	180.06

1. The agent's policy is MassMutual's Blue Chip Enterprise Plus II.
2. The Corporate-owned life insurance policy is MassMutual's Strategic Life 7 (SL7).
3. The low-load policy is Ameritas' low-load Universal Life.

ference between standard and super-preferred underwriting criteria. (Of course, large corporations and wealthy individuals have the right to buy the high-commission retail policy rather than the low-commission COLI policies, but the company's wholesale division has not been driven out of business by the retail division.)

Column D shows the low-load company's cost-of-insurance rates. They have a similar pattern to the COLI cost-of-insurance rates, but are generally higher, reflecting the higher marketing expenses for retail customers. Both companies' rates are almost the same at advanced ages.

A comparison of Column A and Column D shows that the cost-of-insurance rates of the agent's policy are higher than those of the low-load company during the first few years, but are significantly lower in the later years. This is the main reason why the agent's illustrated premium is twenty percent less than the low-load premium.

So now we're in a position to make a conjecture about *how* the agent's proposed policy works. The agent's company pays more for commissions and other selling expenses than the low-load company does. It recovers those expenses through high cost-of-insurance charges and high surrender charges in the policy's early years, and through a relatively high spread between what it earns on its investments and the interest rate that it credits to the policy. The insurance and surrender charges and the interest rate spread are actually higher than what the company needs for expenses and profit. It sets a portion of those charges aside in an internal fund to be used to boost the interest rate and reduce the insurance charges for the small number of policies that it expects to remain in force over the long term. Lapse-supported pricing, combined with the use of a super-preferred underwriting class, allows the company to *illustrate* a premium that is twenty percent lower than the low-load company's premium. If more people keep their policies in force than the actuaries expect, the company has the right to increase the cost-of-insurance charges, eliminate the interest rate bonus, or reduce the base interest rate. This is truly a "trust me" pricing scheme.

Is this conjecture correct? Let's look at the Illustration Questionnaire, a disclosure document developed by the Society of Financial Service Professionals. Here's the key question, and the agent's company's complete answer:

Question: If the actual persistency is better than that assumed, would that negatively affect illustrated values?
Answer: No.

It's well known that 20-year level-premium term insurance is lapse-supported. The agent's company is saying that when you put 20-year level-premium term insurance inside a universal-life policy, it somehow ceases to be lapse-supported.

Do you want to bet your financial security on that? ■

Go to next article.

A Brief History of Lapse-Supported Pricing

The Tontine

In 1652, when France was in need of money to start wars, an Italian banker named Lorenzo Tonti proposed a solution. Citizens would buy shares in a government-run pool that each year would divide the investment earnings among the surviving participants. Decedents' heirs would receive nothing, and when the last participant died, the principal would revert to the state. On paper, this arrangement could provide a handsome annuity to the lucky participants who enjoyed a long life.

The word "tontine" is derived from Tonti's name. In *An Historical Analysis of the Tontine Principle*, by Robert W. Cooper, a tontine was defined as "a scheme whereby those members of a specified group who survive and/or persist receive a future benefit of an unknown amount at the expense of those members who die and/or withdraw from the group." Tontines can be distinguished from insurance arrangements based on survivorship (such as life annuities), by the feature that the ultimate payouts are unknown.

Tonti's idea was put into action in 1670, when a small tontine was organized in the Netherlands. As decades passed, the annual payments to the participants were less than twenty percent of what had been projected, because the annuitants lived much longer than expected.

The French government set up a much larger tontine in 1689. During the next eighty years, France and other European countries organized many variations of the tontine, with mixed success. Tontines were a relatively easy way for the state to borrow money. For the participants, however, they were often pure speculation. Inaccurate mortality forecasts were not the only risk; the contract terms were sometimes unilaterally changed by the issuers, resulting in severe losses for the income recipients.

In the United States, the history of tontines begins in 1867. The eight-year-old Equitable Life Assurance Society had depleted its capital to match the annual dividends of its competitors, and its survival was in jeopardy. To gain a competitive edge, The Equitable created a tontine policy that paid no dividends until the end of ten to twenty years. Decedents forfeited their share of the surplus pool, and early terminators forfeited dividends and cash values. This allowed The Equitable to illustrate large dividends to prospective buyers, while downplaying the reality that the actual dividends would be subject to the board of directors' discretion.

The Equitable's tontine policy was so popular that most of the company's competitors soon offered similar policies. As the companies' grew, their marketing strategies shifted. Instead of competing for customers by offering higher dividends, they competed for agents by offering higher commissions.

The early enthusiasm for tontine policies eventually turned to anger as policyholders realized that they would forfeit everything if they dropped out, or might lose even more if they stayed in. State legislatures investigated, but the insurance industry lobbied successfully against action. When policyholders turned to the courts for redress, they usually failed to get the contracts interpreted in their favor.

To deal with growing public dissatisfaction, insurance companies developed deferred dividend policies (also called semi-tontines) that provided cash surrender values, but all dividends would still be forfeited during the specified tontine period of five to twenty years. This adaptation worked, and sales continued to increase. Many companies found that semi-tontines were more popular than the much less speculative annual dividend policies, because they appealed to the public's dual desires to insure and to gamble.

Semi-tontines led to even greater outrage, however, as actual experience emerged. Many policyholders received dividends that were less than half of what they had expected. Again, state legislatures and the courts did little—until 1905 when the New York legislature formed the Armstrong Committee to undertake a thorough investigation of the life-insurance industry. The Committee's report described mismanagement and corruption throughout the industry. Undistributed surplus that was supposedly being accumulated for the benefit of tontine and semi-tontine policyholders had been squandered on lavish payments to agents and company executives. This, plus lower interest rates and marketing-oriented illustrations, had produced the dividend shortfalls.

The Armstrong Committee traced many of the abuses to the lack of accountability in the management of the surplus funds. Because tontines and semi-tontines did not pay annual dividends, mismanagement could go undetected for many years. Therefore, one of the committee's key recommendations was the payment of annual dividends. This was soon adopted in New York and other states.

Despite the scandals uncovered in the Armstrong investigation, policies with tontine and semi-tontine characteristics continued to be marketed by some companies in some states. Renewed warnings of potential sales abuses were made in trade publications and at industry conferences in the 1950s and 1960s.

As universal life became more popular in the 1980s, some companies used various types of persistency bonuses to make illustrated values look better. One technique was (and still is), to illustrate a higher interest rate after certain periods—say ten or twenty years. The actual cost to a company might be small if few policies will still be on the books, and the company retains the right to reduce the base interest rate to offset the bonus. These bonuses are difficult to analyze, because some of them are a legitimate way of reducing unneeded charges. (Some bonuses are lapse-supported and some aren't.)

In 1995, the National Association of Insurance Commissioners adopted the Life Insurance Policy Illustration Model Regulation, which is now in effect in most states. The regulation prohibits companies from showing illustrated values that fail a lapse-support test, but that test provides a generous safe harbor and doesn't eliminate undisclosed lapse risk. There is also work in progress on revising the Standard Nonforfeiture Law, and that project will affect future pricing practices. Regulators, the industry, and consumer groups are debating how to allow innovative products while protecting consumers.

In today's marketplace, lapse-supported pricing remains a powerful tool that companies can use to create the appearance of low cost, thereby gaining a mar-

keting advantage over competitors whose products provide better value.

Advocates of lapse-supported pricing can find their best case in Canada, where valuation and nonforfeiture laws allow product designs that are not possible in the U.S. The Canadian market offers level-premium term to age 100 with no cash values, and universal and variable universal life with level cost-of-insurance rates. The term premiums and cost-of-insurance rates are guaranteed, so in Canada it is the insurance companies, not the policyholders, who bear the lapse risk. Of course, all of the policyholders still bear the risk that the company's solvency will be in jeopardy if too many people decide to keep their policies in force. ■

The world's most dangerous insurance publication℠

SCHIFF'S INSURANCE OBSERVER

Editor and Writer . . . . . David Schiff
Production Editor . . . . . Bill Lauck
Foreign Correspondent . . Isaac Schwartz
Editorial Associate . . . Yonathan Dessalegn
Copy Editor . . . . . John Cauman
Publisher . . . . . Alan Zimmerman
Subscription Manager . . . . . Pat LaBua

Editorial Office
Schiff's Insurance Observer
300 Central Park West, Suite 4H
New York, NY 10024
Phone: (212) 724-2000
Fax: (434) 244-4615
E-mail: David@InsuranceObserver.com
Website: InsuranceObserver.com

Publishing Headquarters
Schiff's Insurance Observer
SNL c/o Insurance Communications Co.
One SNL Plaza, P.O. Box 2056
Charlottesville, VA 22902
Phone: (434) 977-5877
Fax: (434) 984-8020
E-mail: Subscriptions@InsuranceObserver.com

Annual subscriptions are $189.
For questions regarding subscriptions please call (434) 977-5877.

Lapse-Supported Pricing

Making it Work for You

You can use lapse-supported pricing to get cheap insurance. The trick to making it work for you is to take an activist role. Here are the steps:

Before You Buy the Policy

(1) Ask the insurance company what lapse rates it's assuming in its pricing. Insurance companies are delighted to disclose the details of their pricing assumptions because they want people to make informed decisions. (JUST KIDDING.)

(2) Ask the insurance company for a list of people who have already bought the policy that you're considering buying. Choose a random sample and call them. If they seem clueless about what they've bought, that's a good sign. If their finances are weak and they're in a poor position to pay future premiums, all the better.

After You Buy the Policy

(3) Ask the company for a yearly update on how many people have actually dropped their policies, and compare that with the original estimate that the company provided you with. This will tell you if you need to spring into action (see Steps 4 and 5).

(4) After a few years, give the policyholder list to successful insurance agents that you know. Insurance salespeople are very good at replacing existing policies, because they get a new commission when they do. You can have the best policy that's ever been created in the history of civilization, and there will be at least one agent in your neighborhood who will be able to replace it.

(5) After a few more years have passed, call as many of your fellow policyholders as possible and try to convince them to drop their policies. Tell them about hot new products in the marketplace and warn them of the risks of lapse-supported policies.

Remember, your goal is to exploit the ignorance, overconfidence, and misfortune of your fellow policyholders for your benefit. After all, exploitation is what lapse-supported pricing is all about. ■