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# At Witt's End

## Are You Unintentionally Boosting Insurance Company Profits?
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Over the years, we have focused much attention on how you can choose an appropriate policy from an appropriate company, maximizing policyholder value and minimizing agent commissions whenever possible. However, we haven't given much public attention to a topic that is quite simple - but very painful for policyholders and profitable for insurance companies - the topic of **modal premiums on term and whole life policies**. (This concept is not relevant for Universal Life policies.)

Virtually all term and whole life policies are sold using illustrations that depict annual premiums. However, after the purchase decision has been made, the agent may suggest that paying premiums in a non-annual **mode** such as monthly or quarterly would fit better with the policyholder's cash flow. That may sound reasonable to the policyholder, and the insurance company is not required to state what the effective interest rate is used in computing the modal premiums. **Unfortunately, the outcome often turns out to be anything but reasonable**.

One recent client came to us with a $500,000 whole life policy he purchased in 1996. He was shown an **annual premium of $8,452.50** for life in the original illustration, but he ultimately ended up paying quarterly premiums of $2,239.92 instead. Shockingly, **the effective interest rate for computing those quarterly premiums is 17.1% - and this is far from being an isolated situation.**

Taking into account that someone paying quarterly premiums would earn some interest while waiting to pay the insurance company, we estimate that **on average the quarterly premium approach in this case amounted to a net penalty of $441 each year relative to the annual premium approach**.

In general, a decent rule of thumb is that you are **forfeiting the equivalent of at least one annual premium**, measured at the time of issue, if you choose to pay premiums other than annually over a long period of time.

Another way to look at this would be to determine the opportunity cost associated with paying all those penalties. In this case, if the policyholder paid annual premiums and invested the savings aggressively over a 40-year period, earning an after-tax return of say 7.2% - then those savings would accumulate to **$100,000 at life**

**expectancy.** That is especially impressive when you consider that the **death benefit is only $500,000**.

The effective interest rates used in computing non-annual premiums for policies issued today are still unappealingly high (commonly 5 to 10%) in this low-rate environment. But we especially want you to recognize that if you or your clients have **whole life or term policies with non-annual premiums that were issued between say 1975 and 2005**, then it's very likely those policies use an effective interest rate greater than 10% to calculate non-annual premiums. And in that case, you very likely are contributing significantly to insurance company profits at your own expense.

As always, please do not hesitate to contact us if we can assist you in any matter that requires objective advice regarding life insurance or annuities. Witt Actuarial Services is a **fee-only insurance advisory firm** that derives no compensation other than the fees paid directly by its clients.

All ***At Witt's End*** newsletters are available on our website - click **here** to view.