Episode 2: How to measure (and not measure) whole life efficiency

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John: Hello everyone and welcome to Ohio National's Momentum where we bring financial professionals the news and sales ideas that are designed to help keep you and your practices moving forward. I'm your host John Grevas. This is our second episode.

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Today we're going to be talking about whole life now. We all know the products benefits, for example, guaranteed growth and death benefit, guaranteed growth in cash value. But, for the clients that are interested in that cash value side, how do we determine which product is the best fit for their needs? There's a lot of ways that people do it. There's a lot of ways we could do it. So, today I'm going to be joined in that discussion by Karl Kreunen, Ohio National's Product Marketing VP. So, welcome to the program, Karl.

Karl: Thanks, John.

John: Absolutely. Thanks for joining and let's start off by talking about some of the ways that people try to answer this question.

Karl: Yeah, it's, it's, it's an interesting question. Like a lot of other folks I've gone through, personally, a lot of different ways of trying to figure out how do you determine if this policy is better than that policy for a particular purpose. One of the one of the ways I started off doing that in my career was I would simply compare cash values at some future point in time. So, if we're saving for retirement, it makes sense that perhaps if this policy has half a million dollars at age 65, and this policy has $450,000, but the policy that has half a million dollars would be the one that's better. And, I think that's a pretty common experience for most people. And, if you, if you live in the world of mutual funds and other assets like that, I think that makes a great deal of sense.

John: Right.

Karl: But, I don't know that it's as applicable when you start talking about whole life insurance for a number of different reasons. One of which is this, it's the values at age 90 that are going to help, all else being equal, of course. It's the values at age 90 that are going to drive your income calculation. Because the first thing the computer has to do is figure out how much money you need to have left at the end of the cash flow in order to support the policy going forward. So, if I have more money at age 90, I can take more of it out over that timeframe and generate more cash flow, everything else being equal between the two policies. To me, that's, that's one of the first ways I started looking at, at policies and I got it wrong. 'Cause I didn't really understand how you determined cash flow out of a whole life policy and what, what the drivers were behind that. So, that was number one. Another way people look at that and, and they make that that same mistake, looking at values at age 65 or even values at age 90.

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Karl: The problem happens to be that not every policy is built as efficiently as all the others for a variety of reasons. Some of it's because of compensation that's being paid to the agents. Some of it's because of the charges the company takes out 'cause let's just say they're a less stringent underwriter, and so they tend to have higher mortality, so they've got extra charges coming out from mortality that maybe another carrier doesn't have. Lots of different reasons that could be. And, so then you get into a situation where you're saying okay Karl says look at age 90 cash, policy B has a million one, policy A has a million, so policy B is better. Yeah, maybe. But, one of the questions you might want to answer is out of that cash at age 90, how much of it is my client actually getting and how much has to be reserved for the company later on. And, that's dependent upon lots of different issues. As I said, the expense issue is one of them. Loan charges is another one that adders things like that. So, so there's all sorts of different things going on there, as well. Another way people often look at it is simply internal rate of return. Let's measure the IRR of the, of the, of the policy and IRR is a good tool for a lot of different reasons. It's usually what I use to measure death benefit value. Because at the time of claim with death benefit, the company pays everything out. So, I don't have to worry about what happens later. IRR is a pretty good measure there, especially because policies have different premiums, typically. But, that doesn't necessarily work here, because again, we get back to what I just discussed. It's not just the IRR, because that, that's part of what drives everything, but it's also how much money, of that money you have at age 90 when you stop your, your income stream and you pull out of that policy. So, that's a, that's a more challenging question again, and sometimes people just compare dividend interest rates. And, the biggest challenge with dividend interest rates is when you compare them and I'll, I'll just start off with today, Ohio National is at 5.2%. And excuse me. You know, Mass Mutual is significantly higher than us, as an example. 100 basis points. And, so when you give up that 100 basis points, that's going to make a big difference in values over the next, let's say you're talking to a 50 year old over the next 40 years, when you assume those stay the same. But, the problem with assuming they stay the same is if you go back and you look at history, you can find years where Ohio National had a higher dividend interest rate than Mass Mutual, or another carrier had a different higher, higher dividend interest rate, and so on and so forth. And they don't, they don't really hold steady that, that differentiation, the spread between the two is not a steady spread and it doesn't stay that way. Carriers at various points in time have higher or lower DIR than other carriers for a variety of reasons. And, so my suggestion for most people is when you start looking at dividend interest rate, you actually start looking at history that's a bit longer. Say 30 years, 40 years, if you've got it. And, and start measuring some averages, but when you know that there's a differential of over 30 years, or 40 years, of say 30 basis points between two carriers and the current spread between those two carriers is 80 basis points, you realize you're at the high end of the spread, and it's probably the wrong measurement.

John: Right.

Karl: And, so therefore, you should shrink that.

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John: I would think that carriers, I mean they, these, are companies that are investing over the long term. They're investing conservatively because they have to in order to support those guarantees going forward on these policies, whether it's life insurance or whatever other products they offer. So, I would imagine their investment portfolios don't look all that different. And, ultimately, they're not going to be all that different over the long term.

Karl: I, I think that's an excellent point, John. If you look at most carriers investment portfolios, they're going to be invested somewhere between 65% and 75% in investment grade corporate bonds. And, I don't care if that's Ohio National or any other carrier you want to pick. And, so that you were talking about BBB, A, AA bonds. Most of us don't buy AAA bonds, 'cause the yield you get on a AAA bond is not all that great. The next biggest asset for most carriers is going to be commercial grade mortgage. Where you might have anywhere from say 5, to 5%, up to maybe 15%, in commercial mortgages. Those assets are a little spreadier than bonds, I think is the term our Chief Investment Officer once used. I like it. He used it. He's a professional, I can use it too, right?

John: Sounds, sounds like a technical term to me.

Karl: So, they're a little spreadier than an investment grade bond, so they're attractive. But, the reason there's, they have more spread, is because there is a little bit more risk. If you think today that owning property in downtown Manhattan, I think all of Manhattan downtown, basically, but you, if you own an office building in Manhattan, is a good investment right now. I think you might be mistaken. The pandemic has kept those places shut down. And, I'm willing to bet that as people have learned to work from home, that there are companies out there that maybe you know law office maybe leased the 40th floor of some big office building, that's saying, you know, maybe we don't need all that space.

John: Right.

Karl: And, then after that, things mix up a little bit. Some carriers have more loans than other carriers, so policy loans might be a bigger asset for them. Some carriers might put some money into equities, although typically, that's pretty small. Most equities carriers own tend to be stock of their subsidiaries. So, for example at Ohio National sometimes you'll see another carrier publish something saying, well, they have 4% of their, their money in stocks. Do you want? Do you like that risk? All of our money in stocks is in our subsidiaries, except to a few really small holdings where, uh, a bond got exchanged for stock for some unknown reason that I because of some, some covenant inside the issuing company or whatever. But, we don't buy stocks and most other carriers, don't you wind up with small, small portions here and there for a variety of reasons. And, the bulk of your stock portfolio is simply the companies you own inside your corporate umbrella. But to your original point, now that I've been somewhat longwinded.

John: All good information.

Karl: They're all about the same. And, if you look at yields on the on carriers at various points in time, you might find a yield on carrier A portfolio at 4.5% and carrier B is at 4.6%. And, carrier A has a 5.5% dividend and carrier B as a 6.5% dividend.

John: Right.

Karl: And if you look at that, you think you said well, how much sense does that make? There's ten basis points separating their investment portfolio, about 100 separating their dividend interest rate.

John: So, that difference the, the 1%, the larger difference that could potentially be explained by something more than just the portfolio performance though. Right? I mean carriers have changed the way that they support that dividend interest rate within the last ten years or so, correct?

Karl: I'm glad you asked that question, John. The answer is, yes, things have changed over the last decade. And, there are carriers out there, including Ohio National, who have made a decision to support their dividend scales with other assets besides just the life insurance asset itself. And, and so that started in 2012 when Mass Mutual came out and said they were going to do that in their dividend announcement. Other carriers followed suit. I don't believe everybody has done that, but the majority of carriers have, to some degree or another. We're not heavily supporting our scale. Other carriers may or may not be, that's privileged information. I'm not, I really don't know how much anybody is spending on that. But, I suspect if you're running 100 points more than another carrier, or 80 points more than another carrier, you are probably spending some money there in order to support that dividend scale. And, and so that it, that brings in that third, or fourth, or fifth different element. That is really harder to understand dividends historically are made up of three things. Your dividend interest rate, which is the investment portion supporting the dividend, your claims experience, the mortality portion, and your expense experience. How well you manage your expenses across the enterprise, at least across the life insurance portion of the enterprise. And, and now we've got this other thing that we don't really know about. And, it's interesting because what it essentially is saying, is that if you're taking assets from another location and you're using it to support your scale, then you're effectively stating that you're not making the amount of money you'd originally price that product for whatever that is. And, everybody going to have different numbers there. So, is that a sustainable long term platform for people to plan on? I don't think so.

John: I don't think so.

Karl: To me, right, it feels as though if I'm actually spending, I, I conceivably could be spending more money than I'm actually earning in my life insurance portfolio at some point in time. Because the amount of that support continues every year, 'cause dividends rise every year. And, open the block of, of assets that you're spending it on. And, go up every year because you keep selling new policies and the end result is that I think if you look over 40 or 50 years, it's probably not going to happen. When things stop, it is going to be different for every carrier. I can't predict that, but it certainly feels that, that if a carrier comes back and says oh well, this is justified because this is what we're doing. I would simply say I, I don't think that's sustainable. You weren't doing that 20 years ago, you weren't doing it 10 years ago, you're doing it for a short period of time, and it seems unlikely that that's a good long term answer for anybody. If I'm selling nails and I am supporting all my nail profits with the profits I'm making on my, my, my circular saws, at some point in time, I'll stop selling nails because I'm not making any money at it. And, if that's your primary business, that's a real problem. But, you know, that's neither here nor there. But, it's an important point when you look at the dividend interest rate, there isn't much separating carriers when you look at their investment portfolios. So, there isn't much reason to assume that on a 40 year basis you're going to see one carrier outperform another by a large margin. 25 points, maybe 30 points, maybe something like that. Maybe even 40 but, but not certainly by 60 or 90 or 100. Unless that carrier is taking a lot of risk, and I'm not sure that's what you want out of your life insurance carrier.

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John: So, we've talked about some ways that maybe you don't want to measure whole life efficiency and, you know, its ability to access that cash value. What might be another way that we could look at it?

Karl: Well, I'll go back to how much of that cash can you actually get to? If I have a $1,000,000 at age 90, and I measure over the prior 25 years, and you were able to pull out $10,000 a year. That means you pull out $250,000 out of the $1,000,000 you had. The other $750,000 is doing two things for you. One it's paying interest cost and then it's also sitting around to pay costs for that policy going forward. I’m assuming that you're carrying the policy forever afterwards, you're not letting it die at 95 or 100. So, if I have a policy that can generate $10,000 a year out of $1,000,000, that's a 25% efficiency measure, is kind of how I'm looking at that. If I have a policy that can pull that, that $20,000 a year, well now I'm pulling out over 25 years half a million dollars. That's a 50% efficiency measure.

John: Right.

Karl: That's clearly better than a, a 10%. And, the reason I was starting to focus on the efficiency measure is that takes into account some of the things that are guaranteed in a whole life policy. Many folks who buy life insurance, many agents who sell life, life insurance sell whole life specifically for the guarantees. And, the fact that they're building a guaranteed solution for their customer in as many ways as possible. The only non-guaranteed issue on accumulation is your dividend. And, we've already talked a little bit about that. And, then on distribution, what's guaranteed, and what's non-guaranteed. If you look at our whole life policies, we have built into those policies some things that are good for distribution. One of those is that they endow at age 100, and the reason that's important is that means starting at age 101, they don't mature at age 100, but they endow at age 100. So, at age 101 there is no net amount at risk inside the policy. Your death benefit and your cash value exactly equal. So, the carrier no longer has to hold, has to charge money out of the policy for the mortality. And, you might think that, well, you know net amount at risk at age 99 is so small. How much are you going to charge? Well, think about it from the company's perspective, if you're 99 years old, what are the odds that we think you're going to see 100? They're pretty low.

John: Yeah.

Karl: They might be 5%. Right. I'm not, I don't know exactly what it is, I'm not an actuary. Let's make it 10%. Right. Let's be generous and say 10% of 99 year olds make it to 100. Okay. So, that means if you have $50,000 of net amount at risk at age 99 and only 10% of you are going to make it. So, you could have big loans on your policy when you hit age 100, and because that mortality charge disappears, all of a sudden, you've got the means to offset the interest charge on that. And, if you look at our illustrations, you'll see that in the dividend itself at age 101, and you'll see that, you'll see policies that hit age 100 with big loans on them, and they might have $25,000 of cash at age 100, or $50,000 of cash. And, then the next year they're up to $62,000, the next year they're up to $82,000, instead of sliding downwards in cash value, there sliding upwards in cash value because of the elimination of that mortality cost. So, that's one thing that really helps with that. But, the other thing is, if, if you're looking at our limited pay policies, our 10-Pay, our 20-Pay, and our Pay to 65, which is our Prestige Max policy, those policies all come with a preferred loan rider. That rider states that once the policy is paid-up, meaning you paid your 10 years, your 20 years, you paid to age 65, what have you, depending on the policy and the insured is age 65, then the policy will have a 1% reduction in the loan rate. So, our loan rate right now is 4.4%. But, if you have a client who starts their retirement stream at age 67 out of a 10-Pay contract that they bought when they were 55, well, let's see. They paid their 10 years to age 65. They're 67, so they're over age 65. So, the loan rate they're going to get charged is going to be 1% less on up to 10% of the gross loan value each and every year. So, if my gross loan values $1,000,000, you're probably borrowing on an income stream about 6%, 6.2%, 6.5%, depending on how long you want that income stream to last. You'll always be getting that money out at that 1% lower rate. I think 1% is not a big deal, but in today's interest rate environment when you have 4.4% and you go to 3.4%, that's about a 20% savings.

John: Right. Right.

Karl: So, if I'm reducing your loan cost by 20%, where does that money go? It goes to your client in the income stream. So, what are we doing? We're creating a more efficient policy. So, if you have to, if you think about DIR and cash values, and you understand that they're, they're inextricably in trump, entwined because much of the cash value is driven by your dividend.

John: Right.

Karl: Once you start normalizing those over a 40 year time period, whether you're giving company A or company B a 25 or 35 point benefit on the DIR. Once you start normalizing those because you understand how the investment process works. And, then you start looking at what's guaranteed inside of the policy, that endowment at age 100, that preferred load rider that comes automatically, and it's automatically activated at the right time. Those guarantees are going to be there that create a more efficient contract. And, what we found is when we're running our loans and we're comparing our loans against loans from other carriers, is that our efficiency, um, throughout, pretty much any design I've built so far, hovers around a 60% level. And, other carriers are hovering in that 42% to 52% range, depending on the design, depending on the carrier, you'll find different numbers for different carriers. And, and sometimes the same carrier will have a different number, depending upon the design of the product, and how you're building it, in how you're taking your income stream. So, what starts to become more important when you're looking at any situation where you're taking income, is that the dividend interest rate is at the given cash value at some point in time, or whatever, those numbers are all going to change over time. We don't know what you're going to have at age 65, at age 85, at age 90. We, we just don't. But, what we do know is we can guarantee the endowment and the importance that that brings to distribution planning. We can guarantee a lower loan rate and the importance that can bring to distribution planning. And, therefore we, and as a carrier, Ohio National, is generally, I didn't bring this point up before, but it's generally considered a low-cost carrier.

John: Right.

Karl: I've worked there now since ’92. And I'm a little biased, obviously, because of that. But, yeah, we are low-cost carrier. We, we try to maintain pretty good controls on all of our, all of our costs. And, I think we do a really good job. So, with a lower internal cost, a good underwriting for good mortality experience, or our mortality costs tend to be lower, so that endowment at age 100, that preferred loan rider, some of that's guaranteed. Some of that isn't. But, all of that stuff put together, makes for a really efficient contract in comparison to everybody else we've measured out there in the industry. And, I'm not going to tell you we've measured everybody. When I look at Mass Mutual, when I look at Penn Mutual, I look at New York Life, where I look at Guardian, those are our four biggest competitors. I've looked at Emeritus. I'm having somebody look at Lafayette right now. And, we start measuring things like this. We look great. We come out on top again and again. And, and I think it's an important way to measure if you're doing distributions.

John: Right.

Karl: If you're not doing distributions, if you're more concerned about death benefit at life expectancy, then measuring internal rate return on the death benefit, I think makes great sense at this point in time. There might be another calc I can come up with in my remaining time in the industry. Who knows? It makes more sense. But, right now through all the iterations I've gone through with life insurance and where the industry is today with so much of the premium being devoted to accumulation and distribution planning. I think if you're not measuring efficiency, you're making a really big mistake when you're trying to figure out which carrier is going to better serve customers.

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John: All right, great information. Thank you for sharing that with us today. And for those of you who are listening who want to learn more about this topic and our thoughts on it, we actually created a white paper that goes into more detail on some of the things that we talked about it today. You can find that by visiting us on ON-Net, onnet.ohionational.com, and searching for our whole life efficiency. Or, if you're visiting us on Spreaker, it'll be linked from our page there so you can get to it directly. So, Karl, thank you very much for joining us today. Thank you to all of our listeners and we'll see you next time.

Karl: Thanks John.

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