Vanishing Point of Vanishing Premiums

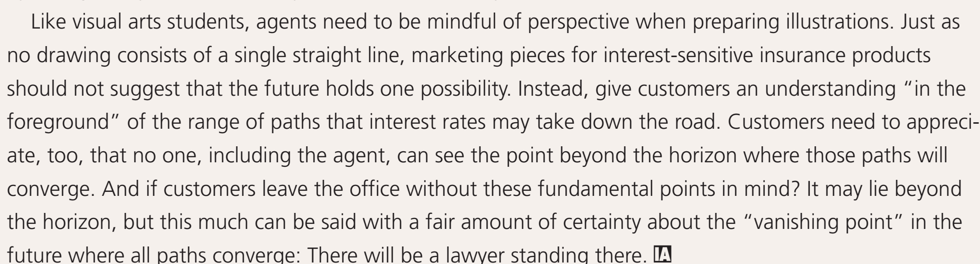
A fundamental of art and architecture is perspective, i.e. the trick of giving two-dimensional drawings a three-dimensional appearance by having seemingly parallel lines converge like train tracks on a point near the horizon. The foreground fills the canvas from left to right, but somewhere in the background all lines converge on a single "vanishing point." So-called "vanishing premium" policies operate in a similar fashion, with a wide range of possible interest rates eventually converging in the future at a particular point. The key question is: What is that point? Where do interest rates wind up?

For decades, consistency and predictability marked the life insurance industry. Conservative investing practices produced steady and predictable investment returns and mortality rates steadily improved. In the 1960s and 1970s, as investment rates began to increase, life insurance companies' investment earnings often exceeded their conservative projections. Standard disclaimers warned that policy dividends were not guaranteed, but it was assumed that it would never happen.

In the 1980s, double-digit interest rates became common. Cash values tied up in life insurance policies earned low rates of return and were diminishing in real value. The notion of "buy term and invest the difference" began to catch on, so companies introduced new products built on more aggressive interest rate and other assumptions. The concept of "vanishing premium" life insurance became immensely popular. The theory is simple: Premiums are paid in the early policy years, cash surplus is built up through investment such that, in later years, the policy becomes self-supporting and the income can pay future premiums.

To market the concept to consumers, agents and life insurance companies created computer-generated policy illustrations that often used optimistic future projections ushered in by the '80s economic conditions. The attractive sales pitch: "This policy ultimately will pay for itself." In retrospect, many of these sales illustrations were based on unrealistic assumptions about future interest rates and insurance company earnings. Because of consumer expectations built up over the years that companies would meet or exceed dividend projections, agents frequently did not take documented steps to ensure that policyholders knew of this risk and the product's volatility. Instead, unfettered by cautionary remarks, these illustrations, along with the agent's glowing representations, convinced many consumers to purchase "vanishing premium" policies.

Problems began to arise in large numbers when interest rates declined substantially. The "vanishing premium" didn't live up to its name, or else it vanished and then returned, prompting a slew of claims against agents and insurance companies. Lawsuits alleged that insurers sold these policies by presenting fraudulent or misleading illustrations about how they worked. Common allegations included fraud, fraudulent concealment and constructive fraud, along with negligence, negligent misrepresentation, breach of contract, breach of fiduciary duty and conspiracy. In addition to spawning individual and class action claims by policyholders, vanishing premium policies also sparked litigation by companies against agents. These cases alleged that the company did not make the misrepresentation; instead, agents misrepresented the policy by telling policyholders that they wouldn't need to pay premiums after a certain point.



Like visual arts students, agents need to be mindful of perspective when preparing illustrations. Just as no drawing consists of a single straight line, marketing pieces for interest-sensitive insurance products should not suggest that the future holds one possibility. Instead, give customers an understanding "in the foreground" of the range of paths that interest rates may take down the road. Customers need to appreciate, too, that no one, including the agent, can see the point beyond the horizon where those paths will converge. And if customers leave the office without these fundamental points in mind? It may lie beyond the horizon, but this much can be said with a fair amount of certainty about the "vanishing point" in the future where all paths converge: There will be a lawyer standing there. IA

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Avoid a Vanishing Act

Self-supporting policies are still around. The key to vanishing premiums, interest rate projection and similar claims from a litigation standpoint is proving that representations made to the policyholder at the time of purchase were reasonable and accurate. To avoid or help defend these claims:

- Avoid the term "vanishing premium." The premiums are always there, so the term can be misleading. Any statement misrepresenting a policy's benefits or coverage can lead to an E&O claim, a lawsuit or action against an agent's license. One misstatement, however slight, can mitigate the effect of appropriate advice, and may be enough to defeat a motion for summary judgment, effectively ensuring that the policyholder's claim will wind up in front of a jury (if it's not settled first).
- Make all necessary disclosures. Many policyholders bought vanishing premium policies due to illustrations with premiums based on the current dividend performance continuing into the future. Inadequate disclosures will not protect you in litigation.
- Document efforts to explain the products' volatility to policyholders in writing and, if possible, have the policyholder acknowledge the same in writing. When disclosures regarding risk and contingencies are oral, the agent becomes a convenient scapegoat if the policy falls apart.
- Don't assume that interest rates will be high. Vanishing premium illustrations were built on assumptions that the '80s high interest rates and investment returns would continue indefinitely. They didn't, and the fallout was costly.

—K.N.