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Guaranteed Universal Life Insurance for Record Low Premiums: What Fiduciaries Need to Know!

by
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Guaranteed death benefit permanent life insurance now sells at prices well below the guarantees of the past. It takes the form of universal life policies sold with "secondary" or "no lapse" guarantees. As a fiduciary who will work with clients who are considering the purchase of this insurance for estate preservation and enhancement purposes and who will want you to purchase it for them or to assume the ownership of such a policy, you should understand the essential features of this product and its potential pitfalls as well as possible rewards.

This product differs from, and has more appeal than, universal life as it has been known since its inception 25 years ago. Universal life policies will normally expire ("lapse") if the cash or account value dwindles to the point that it is insufficient to cover a policy's ongoing charges for insurance and expense costs. With the no-lapse feature or "secondary guarantee," these newer policies promise to stay in effect for the guaranteed period (usually the insured's life) if the premium is paid regularly and on time, even if the cash value has run out.

Long-term secondary guaranteed policies first appeared in the marketplace about a decade ago. But over the past few years, companies have incorporated more and more aggressive pricing to generate lower and lower premiums. Today, the low premiums required for these guarantees have made these policies the hottest commodities in the life insurance industry. Not only are they grabbing a large market share of new permanent insurance; they are replacing many existing policies whose current non-guaranteed projections simply cannot match the guaranteed death benefits of the lowest priced versions of this new product.

The appeal of these competitive guarantees is understandable. The burst of the 1990's stock market bubble and a steady decline in interest rates have lowered investors' near-term expectations and increased the allure of investment guarantees generally. For those who are considered preferred risks, these policies commonly guarantee internal rates of return on premiums paid of 7 percent or more at age 80, 6 percent at age 90 and 5 percent at age 100 – and all income tax-free because of the favorable tax treatment of policy death benefits. At a time of low interest rates at least, what fixed income investment could hope to do better? Is it any wonder that agents have found many receptive prospects for this product?

Traditional Policy Guarantees and Pricing: Historically, life insurance policy guarantees and their pricing have been very conservative. They have been based on interest rates well below the investment returns of many insurance company portfolios (generally around 4 percent) and mortality and expense charges much higher than those actually experienced (a 1980 mortality table for the general population, for example). With such conservative assumptions, the required premium for a certain guaranteed death benefit with traditional products has been relatively high. It

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is often about twice the much lower premium cost for the same death benefit assuming the indefinite continuation of a carrier's current non-guaranteed performance.

Because of the very conservative nature of traditional life insurance policy guarantees, the comparative guaranteed values of "permanent" life insurance illustrations have generally been an inappropriate and misleading basis for evaluating competing companies and products. Current performance, if honestly calculated and projected, is a fairer method of comparison, even though it is certain that future performance will differ from current projections, either up or down, because of changes in investment results and other policy factors.

Guaranteed death benefits at bargain prices come on the heels of disappointment and frustration with the non-guaranteed performance of traditional products. For traditional policies purchased over the past 15 or 20 years, their actual non-guaranteed performance has badly lagged the projections made when the policies were sold. The steep fall in interest rates over this period, sometimes coupled with increased mortality charges, has had, or will have, serious and sometimes fatal consequences for these policies. Policyholders who had assumed, based on a policy sales illustration, that they would only have to pay premiums for a certain number of years are still paying them, or "vanished" premiums are reappearing. More often, those who attempted to purchase the most "permanent" death benefit for the lowest possible premium face the likelihood that, without significant premium increases, all or much of their coverage will vanish before they do. The policies will shrink or disappear altogether not because of an insurer's financial problems but because they are insufficiently funded in light of their actual performance.

It is important to understand that some policies have performed well in light of these trends, especially in comparison to the returns from similar policies or comparable investments. Yet, even these policies, if designed to provide the most death benefit for the least premium or to limit premium outlays to a certain period of years, may have proven disappointing in the manner just described.

The No-Lapse Guarantee Difference: In light of this recent experience, the market for "no lapse" guaranteed universal life with aggressively low-priced premiums has been especially ripe. Guaranteed premiums on these products are generally less than half the premiums required to guarantee the same death benefits from traditional products. Even more compelling, the premiums on these guaranteed policies are often less than the non-guaranteed premium needed to fund the same death benefit in the most competitive traditional product based on a projection of current performance.

The no-lapse policies have little, and possibly no, cash value, in comparison to high cash values in the best traditional whole life policies. By their nature, whole life policies have cash values that grow to equal the death benefit at the age of "endowment" (usually, age 100). The ability of companies issuing no-lapse universal life to avoid paying competitive cash surrender values (i.e., the cumulative investment of premiums less reasonable insurance charges and expenses, including sales loads) to policyholders who terminate their policies is an extra source of profit that these companies can use to pay competitive guaranteed death benefits. However, the argument is made that cash values are irrelevant for those buying life insurance purely for the ultimate death benefit and planning to keep their policies for life.

The Risks of No-Lapse Guaranteed Policies: For clients focused solely on the death benefit of a policy and given a choice between a seemingly guaranteed outcome for one price and the best non-guaranteed alternative requiring the same or even a somewhat higher price, why would or should they not automatically pick the guarantee? The guaranteed option may well make sense in certain situations. Yet, even in these circumstances and otherwise in general, strong cautionary notes are in order. Perhaps surprisingly, while one might logically consider a guaranteed alternative to be the safe and conservative choice, it carries several risks. These relate to (1) the potentially dire consequence of a late premium payment, (2) an insurer's possible financial inability to meet its guarantees, (3) a clear conflict of interest between the policyholder and the insurer as the result of these first two risks, (4) the inflexibility of the guaranteed policy due to little cash value and high surrender charges, and (5) the possible "opportunity cost" of higher returns from the best-performing non-guaranteed traditional policies for insureds who live a long time.

The Risk of a Late Premium Payment: The "no lapse" or "secondary" death benefit guarantee of these new universal life policies has a number of conditions attached to it, such as prohibiting withdrawals or loans or any changes to the death benefits of the policies. The most important of them is that, in most of these policies, premiums must be paid exactly when due or the guarantee could either be forfeited or severely reduced.

Under early no-lapse policy versions, a premium payment only one day late would cost the guarantee. The policy would then lapse when it had no cash value in it. That would already have occurred in many cases when the guarantee is lost because of a late or a missed premium payment.

Increasingly, no-lapse secondary guarantee provisions incorporate an alternative policy design known as "shadow accounts" to minimize the reserves they are required to maintain for these policies and, thereby, to allow for even more competitive pricing. These separately calculated benchmark accounts rely on different and more optimistic guaranteed interest, mortality, and expense assumptions than those used to determine the regular guaranteed account values and may even be more favorable than the non-guaranteed assumptions used to illustrate non-guaranteed account values. The use of these aggressive guaranteed assumptions in shadow accounts has, so far, enabled insurers to skirt the higher reserve requirements imposed by insurance regulations on low-priced guaranteed life insurance in recent years.

The shadow accounts, unlike regular account values, are not accessible by the policyholder in a policy surrender, loan, or exchange. Rather, they determine whether the no lapse guarantee remains in effect. The accounts will stay positive and the guarantee will continue for the full period (usually life) as long as the illustrated premium is paid.

Maintaining the shadow account – and the full guarantee - requires the timely payment of the illustrated premium. Late, skipped, or reduced premiums, policy loans or withdrawals and policy changes can reduce the shadow account value below the benchmark for the desired guarantee period (for example, from a lifetime guarantee to a guarantee to age 85). A policyholder is usually allowed to make "catch-up" payments to restore the desired guarantee period. However, the policyholder may not realize that the guarantee period has shortened until the cost to restore the full guarantee is prohibitive.

In fact, a company may not even notify the policyholder that the desired guarantee has been violated. Indeed, one leading issuer of these low-priced guaranteed policies specifically tells its agents in its product guide that "we do not notify the client when the lapse protection test fails." *Caveat emptor* is the governing rule, not a comforting environment for fiduciaries.

In any case, clients considering these guaranteed policies need to be asked how certain they are that their affairs are, and will remain, structured and organized in such a way for the remainder of their lives (or any shorter guaranteed premium payment period) that, no matter their age, health, and circumstances in the future, the premiums will be paid as required to maintain the policy guarantee for life. Those who are tardy with the occasional utility bill or mortgage payment or who cannot be sure that every bill will be paid in a timely way when their health falters in later years should recognize the risk that inattention to these policies could cause the loss of the guarantee and the value of all the premiums previously invested.

One might ask why the companies issuing no-lapse guaranteed policies have created such harsh consequences – forfeiture of the policy with little or no cash surrender value in exchange for what may have been hundreds of thousands of dollars in premium – for failure to pay one premium precisely on time. It is also fair to ask why state insurance regulators would allow such draconian policy provisions. The cynical but true answer to the first question is that these companies are counting on a high policy lapse rate in order for this business to be profitable. Because they will have to pay so little, and very often nothing, in exchange for a policy lapse or surrender after many years of premium payments, these companies will reap great profits from each policy lapse. They are counting on these funds to pay the death benefits for the remaining policies on which, quite likely, they will lose money (and maybe lots of it) because of their aggressively low premium pricing.

Indeed, it appears that these companies are predicting that the neglect of policyholders will cause at least one late premium payment and a policy lapse in a high percentage of situations. Voluntary policy lapses should be uncommon given the absence of meaningful cash value received in exchange for a policy surrender. Continuing low interest rates would also make these policies seem like an especially good investment value in the future. Indeed, most lapses will likely result from oversight and neglect, often relating to the inability of the elderly to give timely attention to their financial affairs and a delay in having relatives and legal representatives step in to pay the bills. Such a scenario should give pause to most consumers considering the purchase of this product. Maybe one of these days, it will even arouse the sluggish and somnolent state insurance regulators.

Possible Insurer Financial Problems: No life insurance company in recent times has failed to pay a life insurance death benefit because of insolvency. Consequently, it may be hard to imagine that could happen in the future, and one who dwells on such a possibility might be considered a Chicken Little. But the past is not necessarily a prologue for future developments considering the unprecedented nature of the guaranteed death benefit product. Indeed, the red flags have gone up, even if the alarm bells have yet to ring.

Recent (June and July 2004) detailed reports from Moody's, Standard & Poor's and Fitch, three of the five insurance company rating agencies, have issued strong warnings about the future impact of these policies on the companies issuing them. They caution that the premium levels for the lowest-priced products appear predicated on possible overly optimistic expectations with regard to future interest rates, mortality experience, reinsurance pricing, and policy lapse rates. Because premium levels and death benefits remain constant for the duration of a guaranteed death benefit policy, with no possible adjustments in policy pricing or benefits in the event of unfavorable future economic developments and insurer experience, these risks are greatly enhanced.

The factor of policy lapse rates especially concerns the rating agencies and other observers.[1] Moody's and Fitch both estimate that these companies are expecting policy lapse rates of 4%-5% annually. In bold-faced type, Moody's notes "the likelihood that the actual lapse rates are less than pricing assumptions is high given the powerful economic incentives that will be present as these policies age." By this, they mean that the increasing recognition of the value of these policies if interest rates remain low will lead to a high policy retention rate. Also reducing the lapse rate, they predict, will be a ready secondary market for policy purchases at competitive rates for those who want to sell their policies, with the buyers continuing to maintain them until the insured's death.[2]

Both Fitch in its report and Professor Joseph Belth in his March/April 2004 issue of The Insurance Forum cite the history from the 1980's and early 90's of term life insurance to age 100 with no cash values sold in Canada as an object lesson for the possible fate of guaranteed benefit universal life. After a relatively short history, companies offering the product took it off the market because the high expected lapse rates did not materialize. Professor Belth quotes from a 1993 letter of The Great-West Life Assurance Company announcing its withdrawal from the Term to 100 market in which it underscored the large impact on necessary premium pricing and policy reserves from reductions in anticipated lapse rates. In one example, they noted that, at a policy issue age of 40, a 2% lapse rate would require a premium 50% higher than a 5% lapse rate. A change in the annual policy lapse rate from 3% to 2% on a 5-year-old policy would require reserve increases of from 15% to 40%.

An oversimplified but still instructive example further illustrates the potential impact of miscalculating policy lapse rates. Let's assume that a company issues 1,000 policies, each with a $1 million death benefit, to a group of 60 year-olds and figures an average life expectancy of 85. It expects to meet its profit target with a 4% lapse rate. With this degree of policy attrition, only 360 policies will remain at age 85 on which death benefits need to be paid, assuming all remaining policyholders die at that age. But at a 2% lapse rate, there are still 603 claims for $1 million each. The lapses are highly profitable considering that these policies will terminate with little or no cash value in them that the companies will have to pay to surrendering policyholders in exchange for all the premiums collected. So, if the companies overestimate their gains from these policy lapses and underestimate the reserves needed to pay death benefits (in this example by 67.5%), this business could quickly turn from marginally profitable to financially devastating.

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[1] In addition to the Moody's and Fitch reports, Joseph Belth, Insurance Professor Emeritus from Indiana University and life insurance industry watchdog, sharply criticized these policies in the March/April edition of The Insurance Forum that he edits.

[2] Moody's Investor Service, "Beware of What You Price For: Credit Implications of UL Secondary Guarantees for U.S. Life Insurers," p. 6, July 2004.

It is the inadequacy of policy reserves – the assets that companies are required to set aside to pay future benefits - that could cause the insolvency of one or more life insurers if the actuarial assumptions behind these guaranteed products prove materially optimistic. Insurance companies are required to maintain three sets of accounting books – one for tax purposes, a second for GAAP (Generally Accepted Accounting Principles) accounting, and a third for the "statutory accounting" mandated by state insurance laws and regulations. Statutory accounting is most conservative and thus requires the highest amount of reserves, although many companies issuing these guaranteed policies have devised ways to avoid, or at least postpone, its impact (principally, through the use of the "shadow account" policy design). The normally conservative nature of statutory accounting relates to its current use of the industry's 1980 mortality table in calculating life expectancy, asset valuation rules that can understate market values and which disallow the inclusion of certain investments as assets on the balance sheet, and its prohibition of assumed profits from policy lapses.

If there is a day of reckoning for certain companies issuing the guaranteed death benefit product, it may not come for a number of years when the "secondary guarantees" kick in on these products after they have run out of cash value, and the reserve requirements increase exponentially. Even this development may not result in the inability to pay death benefits. Most likely, it could cause one or more statutory insolvencies resulting from the inability to maintain required reserves and to secure the necessary capital to supplement them. In these situations, companies are sometimes sold or merged.

The sale or merger of a technically insolvent company usually occurs as part of or in the aftermath of a rehabilitation plan. Under a typical rehabilitation plan, policyholders can choose to "opt in" or "opt out." If they opt out, they are paid a percentage of their existing cash value. For example, if a company's assets equal 60 percent of its liabilities on the date of insolvency, policyholders that opt out might receive that percentage of their cash value on that date.

Policyholders who opt in are ultimately made whole with respect to their cash values (which are not very meaningful with these policies in any event). But a court supervising a rehabilitation can use its "equitable" powers to force other changes in the policy contract. With secondary guarantee policies, one such change might well be an increase in the guaranteed premium to maintain the same policy death benefit.

Perhaps it is more reasonable to assume that companies would quickly cease selling the guarantee death benefit product if they realize that it is a big money loser. But if experience does not make this result clear until after these policies constitute a large block of their existing business, it may be too late.

A Conflict of Interest between Policyholder and Carrier: The financial risks to insurers if policies are retained in larger than expected numbers place the companies at odds with the clear interests of their policyholders. A potential financial problem thus assumes an ethical dimension.

This dilemma results generally from "lapse-supported pricing." This actuarial practice allocates profits and losses from policies in such a way that the profitability of a product for the company and attractive returns and competitive pricing for persisting policyholders depend on a

high level of policy lapses. The company and the minority of remaining policyholders gain because the departing policyholders are denied a fair return on the premiums they have paid less the pure insurance costs and the recovery of expenses attributable to their policies.

The unfairness of lapse-supported pricing is extreme where the payments of the relatively high premiums required for "permanent" insurance yield little or nothing in the way of cash value for those who drop their policies. Such severe consequences violate the long-standing principle of "non-forfeiture laws" that require reasonable minimum cash surrender values for such policies. Most troubling, this policy design pits the company's financial interest in maximizing the number of policyholders dropping or losing their coverage and forfeiting all or most of their premium investment against their customers' interest in obtaining a reasonable return on those premiums. In short, it poses a conflict that cries out for the attention of state insurance regulators and all those with a genuine interest in the fair treatment of policyholders as well as the financial health and reputation of the life insurance industry.

Inflexibility: The inflexibility of the guaranteed death benefit universal life product relates not only to the requirement of regular and timely premium payments. It is also a function of its limited cash value. Cash value is said to be unimportant for those only interested in a policy's ultimate death benefit. With little of it, however, the policyholder has no future ability to switch policies to a more competitive one without losing most of the initial investment or to use portions of the cash value during the insured's lifetime. The purchase decision is literally a point of no return.

Policy pricing for guaranteed death benefit universal life that is already competitive in a low interest rate period might fall even lower if higher interest rates over a sustained period prompt a further reduction in premiums. Those who buy at one premium price would be hard-pressed to make a switch to a lower-priced product several years later, even if their health permits. The high policy surrender charges and limited cash values would effectively lock them into their existing policies and make them forfeit most of their past investment of premiums if they attempted a policy exchange.

In addition, even though a policy is purchased with only the death benefit in mind, circumstances might change over a long period of years. Especially if the insured lives an especially long time, there might be a desire to pass along some of a policy's value during the insured's lifetime. If a policy is owned in trust, for example, portions of the cash value from traditional cash value policies can be distributed to trust beneficiaries so they do not have to wait until the end of an insured's long life to obtain some of a policy's benefits. Most of the guaranteed death benefit universal life policies are expected to have little or no cash value in them at the life expectancy of the insured or beyond. This flexible use of a policy's "living benefits" is not an option where no such benefits exist.

Upside Potential in Competitive Traditional Policies: The guaranteed death benefit policy features fixed values and pricing. That means the death benefit and the premium will remain constant as long as the premium is paid. Some policy projections show an increasing death benefit at a current non-guaranteed interest rate in the later years of a policy, but it is unrealistic to expect such an outcome and a level death benefit should be assumed. Cash values will fluctuate with

interest rates and other policy performance factors, but cash value is so negligible with most of these policies that it does not deserve much consideration.

By contrast, the death benefit of the traditional policy – or the premium that it costs – may vary from the projections of the original sales illustration. They may fluctuate with future changes in interest rates and related investment results or the company's mortality experience, and cash values will certainly differ from initial projections. While this could ultimately mean a somewhat lower death benefit for the same premium, or a somewhat higher premium to maintain the same death benefit, it is also true that as interest rates increase and if the life expectancy of a company's insured population continues to improve, the death benefit and the cash value of the policy could increase above projections made at a time of low interest rates. Even assuming the continuation of current interest rates and other policy performance factors, many illustrations show a crossover point where the death benefits in the best traditional policies will exceed the benefits of the guaranteed policies, often by very substantial amounts for insureds who live a long time. This crossover point will come much sooner where the best policies and their premiums are structured to reduce commissions and thereby enhance long-term returns. (See related web site article, "How to Make Permanent Life Insurance A Good Investment").

Some examples from our cases in the past year illustrate this last point. In one case, we illustrated a death benefit in a competitive non-guaranteed policy for a 70-year-old woman, at an interest rate .5% below the current rate, that, for the same premium investment, would equal the guaranteed death benefit at age 89 and was 50 percent higher by age 95 ($15 million vs. $10 million), amounting to a 2 percent (200 basis point) rate of return advantage over the guaranteed alternative. We also pointed out that the odds of living to an advanced age for this healthy insurance applicant were high – with roughly a two-thirds probability that she would live to age 89, a rate of return over 8 percent at any point before then, and a one-third chance that she would live to age 95 with an additional illustrated death benefit of $5 million.

In another case involving a 48-year-old woman, the death benefit of the competitive non-guaranteed alternative surpassed the lowest-priced guaranteed policy at age 82, was 50 percent greater at age 89, and 100 percent greater at age 95. The odds of this client living to the age 82 crossover point were almost 80 percent, and, again, the tax-free rate of return for invested premiums was very high at any earlier age.

What is clear from these examples is that the choice of a guaranteed policy may well sacrifice a significant upside potential return from the best non-guaranteed policy structured in the most efficient way. Barring a further decline in the dividend interest or interest–crediting rates of traditional non-guaranteed policies relative to the interest rates assumed in the pricing of guaranteed products, the best non-guaranteed policies will probably produce much higher returns for most insureds who live long lives. If the goal is to maximize returns from an investment of insurance premiums assuming a relatively long life, the most competitive non-guaranteed product will most likely be the better – as well as safer - bet.

Tips for Buying Guaranteed Death Benefit Policies: Even considering the risks, inflexibility, and potential missed opportunity with guaranteed death benefit universal life, some clients will find the low-priced guarantee irresistible. Those who proceed to shop for this product

should carefully follow these guidelines and consider independent and objective assistance in doing so:

- Check the policy language and determine the consequence of a missed premium payment and the means of determining whether a policy has been paid on time. In our experience, agents do not discuss or understand these points and, intentionally or not, give false or misleading reassurance. Policy terms in these areas are deliberately murky and seem designed to cause the high level of policy lapses that will be required for these policies to be profitable to the companies issuing them.

- Review the insurer's financial ratings and trends in ratings, especially from the rating agencies that have most carefully weighed and publicly discussed the potential impact of the guaranteed death benefit universal life product on an insurance company's future financial condition. At this point, those three agencies are Moody's, Standard & Poor's and Fitch.

- Explore the market fully. In recent cases, we have found guaranteed death benefit policies with death benefits 15%-30% greater than the guaranteed products suggested by the clients' agents. Perhaps, surprisingly, in these cases, the lower-cost alternatives have come from companies more highly rated than the carriers recommended by the agent. Without this more thorough review of all the alternatives, these clients would have missed out on millions of dollars in eventual death benefits from policies offered by more financially sound companies than those recommended by their agents.

- Look for reduced commissions and surrender charges. Most of these guaranteed death benefit policies pay extremely high commissions to selling agents. The example in both the Moody's and Fitch reports assumes a first-year commission equal to 99 percent of the premium and annual renewal commissions of 5 percent of the premium. However, we have seen some policies with the flexibility to reduce commissions, with surrender charges lasting only five years, instead of the more common 15-20 year period. This difference not only may result in a higher death benefit, but the much greater cash value allows the flexibility to consider a policy exchange in future years if increasing interest rates result in a lower premium for an equivalent death benefit in a new policy.

- Analyze the possible savings from a "step-rated" or increasing premium guaranteed death benefit policy. A policy that starts with a comparatively lower premium that increases in later years may, in some cases, offer a significant savings over a level premium. Of course, this would especially be the case if the insured dies early enough that much of the higher-level annual premium cost of the later policy years is avoided. But it might also result even if the insured lives a long time. The cost comparison needs to be analyzed on a case-by-case basis. Part of the savings results from a reduced agent's commission, since commissions are based on the initial lower premium.

Conclusion: After three years in which guaranteed death benefit universal life has roiled the market for permanent life insurance and captured an increasing share of both new and existing business, its potential financial impact on the insurance companies issuing it has just begun to receive significant and necessary attention. It is past time to weigh its implications for consumers as well. We hope that the questions raised in this article will prove a useful contribution to that end.

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