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How to Avoid the Premature Death of an Existing "Permanent" Life Insurance Policy

by
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A high percentage of existing "permanent" insurance policies will not make it to the finish line. They will fall apart before the deaths of those they insure if the insured lives a long time. Most of the premiums, other than the amount providing temporary term insurance protection, will be wasted. Policy beneficiaries will receive nothing.

This is a relatively new problem for the life insurance industry. Until about twenty years ago, there were only two types of life insurance policies – term insurance and whole life. Consumers knew what they were buying. Term insurance was understood to be temporary. Whole life assured permanent protection. With the much higher premiums for whole life came a guarantee that the original coverage would remain in place at death, often increased significantly by additional insurance purchased with policy "dividends" over the years.

The "permanent" insurance choices in recent times have been more numerous, complex, and risky. In one form or another, today's policies, especially in larger cases, most often involve combinations of whole life and term insurance. The perceived advantage is the ability to buy more coverage that is assumed to be permanent for an annual premium that may be no more than half the cost of traditional whole life coverage. Not only is the death benefit not guaranteed, its eventual payment is highly dependent on an assumed policy performance that is highly unlikely to occur. When that performance falls short and the insured lives a long time, the policy will collapse. Monitoring this risk and avoiding or minimizing it requires a greater understanding of its origins.

The Race to the Bottom: Much existing insurance has been purchased based on perceptions of lowest price. As insurers and their agents compete fiercely to provide the most "permanent" death protection for the lowest annual premium, they have based policy projections on a number of dubious, perhaps even deliberately misleading, assumptions. (See our separate article, "Why You Should Question Life Insurance Policy Illustrations"). The combination of lower interest rates and investment returns and higher mortality and expense charges than those assumed in the policy illustration will cause most of these low-priced policies to fall apart if the insured (or the survivor of two insureds in the case of survivorship policies) lives a long time. These problems have been aggravated by two overly aggressive illustration practices at the time of policy sale.

The Non-Vanishing or Reappearing Vanishing Premium: The first example of overzealous sales practices has been the "vanishing premium" illustration used to project the point at which policy dividends, perhaps coupled with a surrender of dividend additions (the additional insurance that has been purchased with dividends) will be sufficient to pay premiums. The reliance on continuing high interest rates and perhaps other overly optimistic assumptions in making the rosy projections that were used to sell the policy now, when these assumptions have proven unfounded, causes premium payment obligations to continue for many more years. In some cases where premiums had previously vanished, they are now reappearing, sometimes in much larger amounts than the original supposedly “vanished” premium.

In these situations, it is overwhelmingly likely that, when the policy was sold, the non-guaranteed nature of dividends, which is typically mentioned only in an insurance ledger’s footnotes, was not emphasized. As attention focused on the year in which the figure in the premium column first read zero, the distinction between a policy with a vanished premium, where dividends or policy values are projected to be sufficient to cover it, and a paid-up policy, on which no future premiums are ever due, was almost certainly not explained.

Compounding the incomplete understanding of these points at the time of sale has been the companies’ and agents’ general absence or insufficiency, in most cases, of an early warning to their policyholders of the consequences of declining interest rates -- for example, that a premium designed to “vanish” in year 10 in the original illustration, will, at the current dividend or interest-crediting rate, need to be paid until year 18.

Especially if a whole or universal life policy was purchased within the last 10 to 20 years with the expectation, based on an illustration at the time of purchase, that the growth in policy values would permit premium payments to stop in a particular year without losing the coverage, check again. The news may be very upsetting to insureds and their policy beneficiaries.

The Danger of Underfunded, Vanishing Policies: Worse than the abuses of overly optimistic vanishing premium illustrations are policies sold with “lowball” premiums that are insufficient to sustain them, even if these premiums continue to be paid indefinitely. As discussed above, because of reduced interest rates or other disappointing investment returns or higher than assumed mortality and expenses, or a combination of these factors, the policy is on a path to premature extinction.

These “underfunded” policies usually take the form of either whole life/term insurance or variable life/term insurance hybrids where the term portion is maximized or universal life or variable universal life with a minimally priced target premium based on optimistic assumptions. Both types of policies have lots of term insurance mixed into them, and the non-guaranteed returns from the policy are required to replace the term portions of the policy with permanent insurance. When this does not happen because of declining interest rates and perhaps other unmet projections, three related developments threaten the future of the policy. Reduced non-guaranteed returns leave fewer investment dollars inside the policy to generate additional dividends and cash value growth. With poorer investment results and lower dividends, additional permanent insurance, which must be acquired with these dividends, is not purchased at a fast enough rate to replace the term insurance on the planned schedule. In turn, the continuing presence of too much term insurance as the insured ages increases the policy’s mortality charges and leaves less money left over to accumulate as the cash value reserve inside the policy. As that reserve fails to build fast enough because of reduced investment returns and is, at the same time, depleted with higher than projected insurance costs, there is a good chance that the policy will fall apart before the insured dies.

Some policies from what are generally regarded as reputable companies have gone so far as to offer step-rated or “graded” premiums that depend on dividends to avoid an additional out-of-pocket cost to the policyholder when the future premium increase occurs. In some cases, the premiums do not increase for the first ten years. However, when interest or dividend rates fall or insurance costs go up, dividends will be insufficient to pay the increased premium, and the risk of policy lapse is especially high. This is just an example of the lengths to which life insurers will go to try to appear price-competitive.

The Special Peril of Underfunded Second-to-Die Policies: Nowhere are the hazards of underfunded policies greater, or is the problem more widespread, than in the second-to-die market. Because of the large amounts of insurance often involved, the central importance of these policies to the ultimate success of estate plans, and the gift tax considerations that influence the choice of policies and premiums, an aggressively priced policy with a heavy mix of term insurance is especially risky and, in many cases, irresponsible.

Sad to say, there are many of these types of policies among those already purchased. They may even comprise the majority of existing coverage. Overheated competition among insurers and agents in the big case market, unfiltered by a second opinion from a knowledgeable and objective advisor, has fed the natural tendency of purchasers to focus on perceptions of lowest price rather than on proven and probable comparative rates of return among insurers, based on their historic track records and current performance. Consumers have been apt to fall into the trap of paying too little for insurance, not realizing that this may well mean the policy gives out before they do.

Dependent on unrealistically optimistic assumptions to carry them forward, these policies are imperiled by the unfavorable deviation from illustrated values. Without immediate and major corrective action, these thinly-priced policies will likely lapse before the death of the insureds, leaving no residual value. Estate and business planning, which is based on the assumption that these policies will provide the necessary liquidity, will collapse in the process.

A growing awareness of these situations may encourage sophisticated life insurance consumers and those who advise them to ask more questions about the purchase of new insurance policies than they have in the past. But what can be done to help current policyholders out of their present morass?

What To Do With An Underfunded Policy: In reviewing an existing policy, it is first important to figure out whether a policy is vulnerable to underfunding or has otherwise failed to measure up to the original projections upon which planning has been based. This can be determined by asking the carrier for an "inforce ledger" showing a policy's current status and projecting its performance into the future.

Recognize, however, that this illustration is just as likely to misstate the likely future performance of the policy as did the original policy projection. Because of the widespread use of unreliable assumptions in illustrations, it is essential to look beyond and behind the illustration to first determine its implicit assumptions. These should then be compared to benchmark industry standards. A review of historical company performance data indicates any appropriate adjustments, and then the original illustration should be re-run with a weighting factor based on these findings. We call this process the "reverse engineering" of a life insurance policy illustration. It is a key part of our business. Agents and brokers cannot perform this function because they have no ability to adjust the mortality and expense assumptions in their illustrations. (For further details, see pages 21-22 of our article, "What Sophisticated Investors Should Know and Ask about Life Insurance").

Where the "reverse engineering " analysis reveals or confirms that the policy is in danger of lapsing before the death of the insured, possible corrective action includes: (1) pay a higher premium, (2) reduce the death benefit, (3) seek the internal modification or replacement of the policy with the existing insurer without new underwriting, or (4) replace the policy, if health factors permit new underwriting with acceptable results, with a new policy that can be expected to offer a better long-term return. Replacement, may also be warranted, where the present and likely future performance of the current alternative lags significantly behind the likely risk-adjusted returns of a viable alternative. The questionable financial strength of an existing insurer is an additional possible reason to seek a policy replacement. There are a number of precautions to observe in pursuing a policy replacement, however. These are discussed in detail on pages 24-26 of our article, "What Sophisticated Investors Should Know and Ask about Life Insurance."

The likely failure of a high percentage of the "permanent" life insurance purchased over the last 20 years remains a largely unknown hazard. But the storm clouds are clearly on the horizon. Those who recognize the dangers before they arrive and seek immediate remedies will be most successful in averting the coming devastation to countless estate and business plans which these policies were designed to fund.

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An estate planning lawyer prior to joining NML, Barkhausen is a member of the American, Illinois, and Chicago Bar Associations and the National Conference of Commissioners on Uniform State Laws. He has written for and spoken to these organizations on estate planning and life insurance topics, and he has also conducted Continuing Professional Education seminars for the Illinois CPA Society on the business and estate planning applications of life insurance.

Barkhausen graduated with high honors from Princeton University in 1972 and in the first class of the Southern Illinois University School of Law in 1976. He and his wife, Sue, live with their sons, Wicks and Billy, in Lake Bluff, Illinois.