BY ROBERT M. BARNES, CLU, CHFC

'Déjà spew'

History repeats itself!

When I entered the life insurance business in 1986, interest rates were at a 10-year low of 7.5 percent, and mortgage rates for a 30-year fixed term were above 10 percent. To put the era in context, the prime rate had hit an all-time high of 21.5 percent just six years earlier.

Taking a look back at insurance developments over the last 30 years might illustrate why these innovative products were created and how they can be used today. At the very least, it will give advisors and clients a greater understanding of the complex questions they need to ask as they plan for decades of insurance coverage and financial stability in retirement.

Universal life

When universal life insurance was a new product, some questioned its value or its viability, but many others fell in love with it. Double-digit interest rates paying on cash value was much more exciting than a stodgy whole life policy that might reach 6 percent, if you were lucky. Add to that the flexibility to skip a premium or pay less today for more pure insurance protection, and universal life became even more appealing.

The pitch was simple: Accumulate savings, protect your family, and get tax-deferred growth with the ability to take "tax free" income at retirement. I know of many who were told to borrow from their whole life policies or to exchange them into universal life policies. Projections at the time forecasted that you could buy more insurance and pay the same premium or, in some cases, pay no premiums at all. (The reality, however, is that projections are not guarantees, and they don't always come true.)

Contributing to attractive universal life illustrations was the introduction, in 1980, of a new life expectancy table reflecting longer life spans, which resulted in lower insurance charges. More flexibility, more control, attractive rates, and lower cost of insurance all made for exciting illustrations.

Universal life insurance was in its heyday. It had turned the life insurance world upside down and was eating into the tenured sales volume of whole life and term insurance. But then a new type of life insurance called "variable universal life" emerged.

Too good to last

The timing for variable life was perfect. After the stock market crash of 1987, we had one of the longest bull markets in history. Sales of variable universal life policies quickly exceeded those of universal life policies. Projections of up to a 12 percent return were allowed—10 percent was considered conservative. These policies were the latest and greatest thing around.

You know the rest of the story, right? We had a stock market crash, and interest rates fell sharply. Those who paid little for their insurance, relying on high interest rates or great market returns, found out they needed to pay more into their policies. Their options were even more limited if their health had declined since they purchased their last insurance policy.

The difference between universal life and variable universal life has to do with the investment or interest-crediting choices. In a universal life policy, cash value is secured by the company's general account, and you are paid an interest rate, usually off of the company's formula or benchmark. Variable universal life, on the other hand, offers an array of investment sub-accounts. These "sub-accounts" work very similarly to a mutual fund. As the product evolved, carriers added more choices, sometimes in excess of 50 sub-accounts.

If I were to draw you a picture of a universal life policy, it would be a bucket of money with a hole in the bottom. The hole would grow larger as you age. If you can't fill the bucket fast enough, you have a problem.

In recent years, I have examined policies that are not able to accept enough money to make the policy last as long as the insured is expected to live. In other words, they can't shove enough money in the bucket because of the increasingly larger hole in the bottom. The hole in this example represents the mortality curve, which is similar to the upper-sloping bond yield curve. The older they are, the sharper the curve.

Making it worse is that the carriers have a "current" and "guaranteed" set of mortality rates. In other words, they have the right to rip the hole open even wider.

A universal life policy subjects the owner of the policy to interest and mortality risk. The only factors a policy owner controls are the amount and timing of premiums. Variable universal life policies add market risk to the mix.

So as the thorns of universal and variable universal life became apparent, clients increasingly wanted to be sure that if they paid their premiums they wouldn't have any surprises down the line. This led to the introduction of guaranteed universal life (aka, "secondary guaranteed universal life") in the early 1990s. And a new trend was born.

'Permanent term'

With guaranteed universal life policies, a guaranteed death benefit took the mortality and performance risks off of the policyholders. In exchange, the policies demanded the timely payment of all premiums.

These policies zapped much of the flexibility out of universal life insurance. They took the best features of term insurance and married them with the best features of whole life. Unlike with term,

this coverage could be designed to last to age 100 and beyond. Similar to whole life, clients were guaranteed a level premium, but at a substantially lower cost, because it built very little cash value in the policy. It is considered "secondary guaranteed" because, unlike whole life insurance, in which the reserves are inside the policy and accessible, the reserves are held at the company level. I like to refer to a guaranteed universal life contract as "permanent term" insurance.

Whenever a problem meets a good solution, things can ignite. As universal life and variable universal life policies issued in the '80s and '90s were audited, clients didn't like to see how much more premium they needed to pay to maintain their policy to a decent life expectancy. When clients or advisors looked at guaranteed projections under these policies (which were generally the guideline level premium), it was alarming for a client to discover they could pay that much premium and still not have coverage.

When you compared the premiums required to keep a universal life or variable universal life policy in force to the same stream of premiums on a new guaranteed universal life policy, it was clear that the client could save money and guarantee the policy would not lapse if premiums were paid in a timely fashion. Policyholders could now take the risk of mortality and performance off their shoulders and put it on the back of the insurance company. Thus, a lot of life insurance sales made in the 2000s involved a 1035 "tax-free" exchange from a universal, variable universal or whole life policy to a guaranteed universal life plan. The quest for the lowest-priced guaranteed universal life policy was on!

Indexed universal life

Toward the end of the decade, some insurance rates were at their lowest point in history, and carriers started to wonder if they could support current guaranteed universal life pricing. Add to that new actuarial rules that increased reserve requirements (in order to curb some of the more aggressive pricing in the marketplace) and a market meltdown in 2008, and you now had the perfect storm for an indexed universal life explosion.

Carriers needed to lighten the growing strain of offering guaranteed universal life coverage. Industry-wide, prices increased, guarantees were shortened, and some insurors exited the marketplace altogether.

Indexed universal life was the clear solution. Cash values for indexed universal life looked a lot more exciting than those for regular universal life, since they were very interest-rate sensitive. Carriers could illustrate a "hypothetical historical" return and a nice rate of return in the high single-digit range—your money grows tax-deferred! You can't lose!

Best of all, they could illustrate variable loans, which allowed policyholders to make money off of borrowing money. Carriers could now "illustrate" a loan arbitrage play: If you borrow at 5 percent and make 7 percent from your index account crediting, your total outstanding loan balance will result in a positive 2 percent.

You know where the story is heading—it's a story you can sell!

Reality check

But it doesn't have to be this way. When I first discuss indexed universal life with advisors or clients, they assume I don't like or recommend the product, which is not correct. I believe that indexed universal life is here to stay, and I will consider choosing it instead of a traditional universal or variable life policy. I think it offers some upside that universal life can't reach. And although it might not match the long-run growth rates of the market, it will be a much safer ride along the way.

Below is a comparison of indexed universal life and variable universal life projections from the same insurance carrier, holding the variable as close to a match as possible. I used the same carrier, assuming that the "cost of insurance" in one policy chassis might be similar to another.

The bottom line: the loan arbitrage income certainly is more exciting than the standard "surrender to basis then borrow" method. Anyone would take $117,000 of annual income over $84,000.

Let's compare

In order to get the same income from a variable universal life policy, we need to project a 10-percent gross rate of return. Of course, reality tells us you won't and can't earn the same rate of return each and every year. There will be zeros, and there will be years when the market ends up only slightly positive. Loan arbitrage won't always be positive, which likely means less than projected income for the client.

If you are trying to manage expectations, it makes sense to tone down the aggressive illustrations. Carriers are adding attractive features such as uncapped accounts. They are using carefully calculated historical look-backs to "justify" the higher return they use as an illustrated default.

There is another piece of this story that I find concerning. We are still discovering underperforming and underfunded policies. Those who haven't or won't review their universal life chassis policy are going to find this out too late. They will receive a surprise letter telling them to pay a lot more to keep their policy from imploding. One day, our retiree is going to

40 Year Old Female, Preferred Nonsmoker Risk		
$500,000 Death Benefit		
	Index UL	Variable UL
Gross ROR	7.60%	8.30%
Net ROR	7.60%	7.60%
Cash Surrender Value @ Age 65	$ 899,000	$ 899,000
Annual Distributions start at age 66, for 20 years		
Surrender Basis & Borrow (Fixed Loan)	$ 84,000	$ 73,000
Surrender Basis & Borrow (Variable Loan)	$ 100,000	N/A
Loans Only (Variable loan)	$ 117,000	N/A

take another $117,000 loan from her indexed universal life policy for income and be told that the over-loan protection rider was activated, and she can't pull any more money from her policy. If she loans out more money, her policy will lapse, and all those "tax free" loans will be added to her ordinary income tax bill that year.

Why did I title this article "déjà spew"? Because it sounds like the same story I have heard before. We over-projected—some would say over-promised. We under-delivered and disappointed many clients. We sold policies and neglected to monitor them. And now we're doing it all over again.

What can we do now?

First of all, let's keep it real. Some guidelines for illustrations would be to project a rate two points lower than the illustrated "default" rate. You can also look at the carrier's current (fixed rate) universal life plan and project one or two points above that rate. If you choose to illustrate loan arbitrage, present a second illustration that *doesn't*, so a client can understand she will likely be somewhere in between. Next, don't believe all of the hype, and consider whether the universal life chassis is really the best. If a carrier has the ability to increase cost of insurance or change caps and adjust loan rates, don't you think it might be possible they will?

Illustration software could certainly improve. Wouldn't it be nice to be able to reflect a few years at a zero return? Wouldn't it be realistic to illustrate negative loan arbitrage years, when the entire loan balance may be charged a 6-percent accrual rate? If all of these moving parts are concerning, then perhaps consider whole life insurance. If you utilize coverage from a quality mutual, you will have guarantees and historical performance with a reliable track record.

So far, from my vantage point, the new and exciting has fallen short of the tried and true. The good news is that regulators are making an effort to stop the madness and are in the process of designing a proposal to set limitations on maximum illustrated rates as well as loan arbitrage.

During my career, I've watched the insurance industry develop new products and have seen insurance agents (and clients) flock to them. The abundance of product chassis along with features and riders available today can be overwhelming and misunderstood. Many don't understand the details and, even worse, some don't care. Life insurance is an important part of an overall financial plan. It is becoming an even more important tool when planning for longevity. It is important to ask the right questions, to question the "projections," and to understand the difference choices available in the marketplace.

Robert M. Barnes, CLU, ChFC, is president of Integrated Insurance Consulting, LLC, a NAPFA Resource Partner located in Orland Park, IL. Contact him at rob@intinsconsulting.com or 708.307.2577.