By Robert M. Barnes, CLU, ChFC, CWPP™

Stress testing your life insurance policy

"Stress testing" is a phrase often used in the banking industry. However, few know how it applies to life insurance. This article addresses how stress testing relates to guaranteed universal life insurance.

Guaranteed universal life (GUL) insurance was introduced in the late 1990s and has become quite popular over the years. It combines some of the best features of term and whole life insurance. Similar to whole life insurance, a GUL policy can be guaranteed until death but without requiring the cash reserves inside the policy—thus producing a considerably lower premium than whole life. Like term insurance, a GUL policy is able to have a guaranteed level premium with a guaranteed death benefit. GUL can best be understood as "permanent term" insurance with the flexibility to designate how long it will last while guaranteeing a level premium.

For a number of years, GUL became the hottest selling permanent policy in the industry. Today, fewer companies offer GUL, in large part due to sustained lower interest rates, higher reserve requirements, and guaranteed pricing risks for the company. Some insurance companies are concerned about taking on the risk of guaranteeing premiums and choose to market other UL chassis (current assumption, variable, and indexed), shifting mortality and performance risk back on the client.

GUL is still a favorite of many advisors due to its pure risk and fully guaranteed nature. Unfortunately, many make the same mistake they do with term insurance when suggesting GUL coverage to a client: buy based on the lowest cost. Many advisors are unaware of the risks associated with GUL. Some even design policies to last to an age an insured could outlive, without understanding the potential negative impact or surprise it might present later.

You get what you pay for

Purchasing a GUL policy based solely on the cheapest price could be something a client pays dearly for down the road. This has to do with the very nature of GUL coverage. One of the big reasons universal life policies became so popular was their flexibility, offering the ability to skip premiums or pay lower premiums because the investments did well. GUL insurance still offers flexibility, but you could pay a steep cost if you use it.

This is the reason I like the "permanent term" description for GUL. We all know if a term premium is not paid, the policy will lapse. Likewise, this could certainly happen in the earlier years of a GUL policy, but more likely it will negatively affect projected guarantees later on. Therefore, it might be a good idea to pay a little more today for more flexibility tomorrow.

A straight (non-blended) whole life policy is always properly reserved by its cash value. GUL needs to be properly reserved as well. Unlike whole life, the GUL policy is often only properly reserved at the company level, as there is generally little to no cash value. The actuarial design of a GUL policy is a formula that is premium tested at least once a year by the insurance company.

When GUL entered the marketplace, some companies didn't offer a grace period. Today, most do. Additionally, an insured can actually be penalized for early premium payments on a policy. Imagine the surprise for that diligent client who pays before the due date, but finds out years later the guarantee has actually shrunken due to advanced payments. Like any other policy a client owns, these need to be reviewed and adjusted as necessary.

Figure 1

Insurance Company	Annual Premium	Guarantee Duration (Age)	
		Continuous Pay	Skip Year 11 and 21
Company #1	$ 4,440	105	98
Company #2	$ 4,550	105	96
Company #3	$ 4,630	105	91
Company #4	$ 4,730	105	94
Company #5	$ 5,040	105	94
Company #6	$ 5,110	105	95
Company #7	$ 5,570	105	72

Stress testing and pricing GUL coverage

What appears to be simple might turn out to be more complicated. GUL policies should be actively monitored to assure the initial design is still on target or adjusted earlier to get back on target. Because of this, advisors should consider a policy that works better when stressed.

Let's dive into the details and review some examples for better understanding and clarity.

There are two distinctive ways to price GUL coverage. A company can use a "shadow account" or a "cumulative premium" approach.

A "cumulative premium" approach, as it sounds, measures the full amount of premium a company is supposed to have received at any point in time. It could add a cost for time value of money, and if payments have been skipped or consistently late the policy will be off track. In order to get back on track, premiums will need to be made up, perhaps with interest.

A shadow account is an actuarial formula based on certain projected assumptions. It uses both premium and rate of return assumptions. If a policy is off track, it will often cost much more to get back on track due to the interest drag on the formula.

Figure 1 shows a sample pricing grid. We have a 50-year-old male, preferred non-smoker with $500,000 of GUL coverage. He has longevity in his family and is looking to guarantee coverage to age 105 with continuous premium payments for the duration of his policy. What happens if he skips just two premium payments in years 11 and 21? The results are certainly not equal, and the highest priced option actually works the worst under this "stress test."

When you skip a premium early, it can have a major negative effect on the policy. In Figure 2, we project skipping premium in year three. Note that our bottom two companies will lapse their policy, while others will require roughly 10 percent more in premium for the life of the policy to restore the guarantee back to age 105. Thus, missing a premium in the early years of a GUL policy can prove to be costly.

What if our client stops paying the planned premium after 30 years? How long will each policy last? This could be an example of our 80-year-old no longer able to pay his premium, as shown in Figure 3.

Lastly, Figure 4 looks at the danger of designing a policy for too short a period of time. This could happen for those advisors who incorrectly predict when a client will die, or for that client who insists he won't live longer than 85. We project an initial design guaranteed to last to age 85, with the need to extend coverage further. If the insured is still living at 85, look at the premium requirements to extend coverage for another five or 10 years. We then calculate the "catch-up" premium needed to carry the guarantee back out to age 105. There is quite a difference between the companies.

The last example of having to pay the age 105 catch-up premium is what many have experienced in the last 10 years on a previously purchased UL or VUL policy that has been severely underfunded, severely underperforming, or both.

Begin with the end in mind

What should we learn from all of this? What should we do about it? How can we do better?

As Stephen Covey taught us, "begin with the end in mind," It starts with common sense—buy quality, not price. Do your homework and learn the right questions to ask. Begin with the end in mind and design accordingly. Consider suggesting that clients pay a little more each year to allow them to pay less or skip a premium later if needed. Design their policy to be paid up before retirement when possible. Monitor their policies like their other assets. Make modest adjustments along the way before clients receive disturbing news later. Don't assume every agent selling life insurance knows or understands this, and be even more concerned if they don't care.

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Figure 2

Initial Guarantee Duration to Age 105, Skip Premium Year 3			
Insurance Company	Annual Premium	Guarantee Duration (Age)	Premium to Maintain Age 105 Guarantee
Company #1	$ 4,440	88	$ 4,810
Company #2	$ 4,550	97	$ 4,840
Company #3	$ 4,630	90	$ 5,060
Company #4	$ 4,730	95	$ 5,000
Company #5	$ 5,040	52	Lapsed
Company #6	$ 5,110	93	$ 5,500
Company #7	$ 5,570	52	Lapsed

Figure 3

Initial Guarantee Duration to Age 105, Stop Paying Premiums Yr 31+		
Insurance Company	Annual Premium	Guarantee Duration (Age)
Company #1	$ 4,440	83
Company #2	$ 4,550	96
Company #3	$ 4,630	90
Company #4	$ 4,730	93
Company #5	$ 5,040	94
Company #6	$ 5,110	92
Company #7	$ 5,570	83

Figure 4

Initial Guarantee Duration to Age 85				
Insurance Company	Annual Premium	Premium Required at Age 86 to Extend		
		5 Years	10 Years	To Age 105
Company #1	$ 4,010	$ 40,920	$ 40,920	$ 42,400
Company #2	$ 3,560	$ 16,830	$ 29,000	$ 38,580
Company #3	$ 4,000	$ 14,850	$ 16,780	$ 19,400
Company #4	$ 4,070	$ 4,070	$ 16,850	$ 20,100
Company #5	$ 4,280	$ 5,220	$ 18,930	$ 26,720
Company #6	$ 4,330	$ 15,490	$ 16,160	$ 16,850
Company #7	$ 5,320	$ 5,340	$ 5,340	$ 16,850

Lowest price doesn't always signify the best choice

Don't make the mistake of only looking at the "lowest price" term for your client.

Building flexibility into a life insurance plan can be an important consideration. With term insurance, the flexibility is knowing that it can be converted to a permanent policy later in life if coverage longer than the initial policy duration is required. This is where quality will matter. Often, the cheapest companies have less desirable conversion options. The most client-friendly option to look for is a policy providing the longest conversion period with the broadest availability of permanent policies to convert to.

It is best to look for coverage that will contractually guarantee a policy conversion and to be wary about a number of companies whose conversion offerings are a "business practice." When dealing with insurance companies, I like to see things in writing and in the contract. The reality is, some of those "business practices" have changed or could change down the road.

The typical conversion period is usually (but not always) equal to the initial length of the term coverage capped at age 65 or 70, with rare exception. The best conversion option would contractually allow you to convert to any policy the company offers at the time of conversion. The less desirable ones only allow conversion to the policy they designate as their "conversion policy" (typically higher in price).

There is a cost to have a more generous conversion offering to the insurance company. They have to limit "reverse selection," as typically the unhealthy clients convert and the company winds up with increased mortality without properly pricing it. One might say "what they giveth up front" (cheaper prices) "they taketh away later" (higher priced permanent conversion option).

One of the first questions I ask when discussing term insurance with a client is, "Will you ever want to convert it?" Sometimes, it makes sense to pay a little extra up front to gain more benefit and have more options down the road. It's also important to ask if they would like the option to lower coverage later, as many companies do not allow it. —Robert M. Barnes.