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the extra degree

THE LOOMING LIFE INSURANCE CRISIS©

WHY UNIVERSAL LIFE INSURANCE POLICIES ARE FAILING AT AN INCREASINGLY RAPID RATE

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Executive Summary

Your Life Insurance Policy Is Likely To Expire Before You Do.

Prior to 1979, apart from term, the primary form of life insurance purchased was Whole Life. In exchange for a guaranteed premium paid timely, the insurance company guaranteed to pay the face amount upon death. This product design is not as common today.

Since the early 1980's, Universal Life has been the most popular form of permanent life insurance. Except for the relatively new, no-lapse guaranteed universal life, the performance of a universal life policy is dependent upon complicated math that integrates premiums paid, interest or investment earnings, policy expenses and the cost of insurance charges (aka mortality charges).

When a Universal Life policy is initially purchased, the buyer is generally provided a proposal or "illustration". This illustration is a complex form of calculations which attempts to provide a forward, year by year projection of premiums, cash values and face amount to age 100 or some other targeted age. The projection incorporates numerous assumptions as to future expenses, interest rates, dividends or other forms of crediting that are unlikely to be realized as illustrated yet are critical to the policy's performance. If not realized, the policy may lapse worthless unless substantial additional premiums are paid. Often, by the time the actual performance is discovered, it may be too late to save the policy resulting in all coverage and cash values lost.

The Danger of Falling Interest Rates Coupled with Increasing Policy Expenses.

- The past 31 years of declining interest rates have caused actual Universal Life interest rate earnings to be meaningfully less than originally projected.
- The performance of Variable Universal Life with its "equity base" earnings was materially impacted by the stock market decline of 2008.
- With non-guaranteed Universal Life and Variable Universal Life policies, companies reserve the right to increase current policy expenses to a maximum guaranteed level. Many have increased policy expenses due to the lower interest rate environment. Others have increased them simply because they can. And, unfortunately, regulations do not require they inform you of an increase. The result is policy expenses in both Universal Life and Variable Universal Life has likely been meaningfully greater than originally projected and the policyholder is unaware of the impact upon the policy's performance.
- Given falling interest rates and increasing policy expenses, premium levels are not sufficient to create the actual reserves needed to prevent a policy termination.

Case study: Jack Smith, age 45, $1,000,000 Universal Life policy

During a time when interest rates were at 8% - 10%, Jack purchased a life insurance policy with a premium dependent upon a 7% interest crediting rate. Conservative at the time. At this level of interest, the policy was projected to remain in-force to age 100. But what if the interest earned was 5% instead of the projected 7%? At 5%, the policy lapses at age 86 and coverage terminates unless Jack deposits additional premium.

Alternatively, what happens if the life insurance company decides to increase current policy expenses to the guaranteed maximum and Jack continues to earn 7%? In this case, the policy lapses at age 65 and coverage terminates without additional premium paid into the policy. Even if the policy earns 10% annually, it stills lapses at age 65 because the guaranteed maximum expenses are so much higher than projected non-guaranteed expenses. In this example, the non-guaranteed projected expenses are $41,262 at the end of ten years and $82,305 after twenty years. The guaranteed maximum expenses are much higher. At the end of ten years they total $149,086 versus non-guaranteed expenses of $41,262. At the end of twenty years the guaranteed expenses are $354,481, a 330% increase over the non-guaranteed expense projection of $82,305.

While non-guaranteed life insurance is considered “permanent” insurance, it can expire well before life expectancy due to lower interest rates, a falling stock market, increased policy expenses by the carrier or some combination of those factors. The payment of planned premiums does not guarantee the policy will remain in-force.

Fortunately, there are usually efficient and effective solutions if identified early. One can…

- Add extra money to maintain the current death benefit.
- Reduce the face amount which lowers the cost of insurance.
- Some combination of the above.
- Exchange the policy for a new one with lifetime guarantees, if your health permits.

Anyone who owns a form of Universal Life Insurance policy would be wise to contact their company (or their agent) and obtain an in-force reprojection and analysis to determine its actual and expected future performance.

It is worth noting that the thought of replacing a policy often runs contrary to the conventional wisdom of “it is almost always better to keep what you have than to make any changes.” That may have been true in the past but quite often a problem policy can be rescued by replacing it with an updated one that is fully guaranteed. However, never replace an existing policy until a more favorable one has been issued and accepted.

The Looming Life Insurance Crisis

Universal Life insurance policies are failing and failing at a rapid rate. They are failing the industry, individuals and their families. But the families are the ones left with the problem because failure means the policy will probably not be there when the payout is needed the most. The public and even life insurance agents themselves are largely unaware of the magnitude of the problem.

The Problem is Persistently Low Interest Rates Coupled with Increasing Mortality Costs.

Overview of Life Insurance

Prior to 1979, apart from term, the primary form of life insurance purchased was Whole Life. Most Whole Life policies were simple. In exchange for a guaranteed premium paid timely, the insurance company guaranteed to pay the face amount upon death. This product design is not as popular today as in the 1970's.

Unlike Whole Life or Term, with Universal Life, the length of time that coverage is in place is not guaranteed and can change mid-policy. Its performance depends upon numerous assumptions that integrate premiums paid, interest or investment earnings, policy expenses and cost of insurance charges (aka mortality charges). To complicate it even further, these assumptions are then forecasted to remain the same for the life of the policy, which is generally age 100 or longer. It is impossible for these assumptions to be realized as presented yet they are critical to the policy's performance. If not realized, the policy may lapse worthless unless substantial additional premiums are paid.

To better understand why this is occurring and potential solutions, it is helpful to provide more background on the "evolution" of Universal Life insurance and how the industry has, since the 1980's, passed much of their risks to the policyowner.

In 1979, E.F. Hutton & Company, a large U.S. Stock Brokerage firm, "invented" Universal Life. It was developed, in part, in response to the high interest rate environment at that time. Rather than requiring a fixed premium and guaranteeing a face amount, non-guaranteed Universal Life offered flexibility as to the amount and frequency of premium payments and face amount.

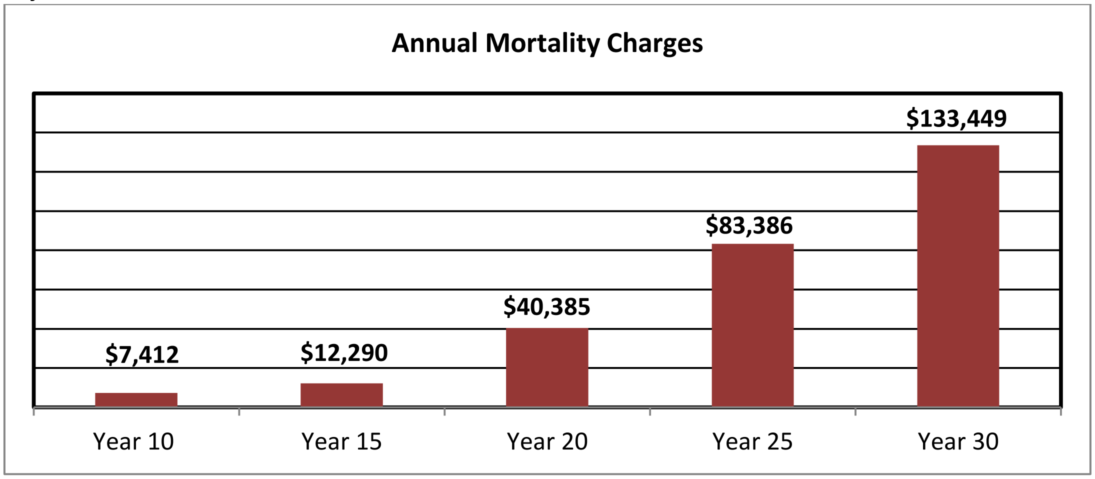
Non-guaranteed Universal Life (UL) comes in three variations:

fixed interest rate Universal Life
variable rate Universal Life
indexed rate Universal Life

Most Universal Life policies purchased in the 1980's, 1990's and early 2000's were non-guaranteed products. Unlike Whole Life, the premium, face amount, interest earnings and policy expenses of the Universal Life policy were assumed projections and NOT guaranteed.

Increasing Cost of Insurance Charges

The most significant ongoing policy expense is the Cost of Insurance (aka mortality charge). This is an annual charge (deducted from premiums and/or cash values) and typically increases each year as one ages. By the time you reach your seventies, it is quite expensive and if you live into your eighties, it is prohibitively expensive often causing the policy to lapse. While varying by company, the following annual projections are from a major insurer.

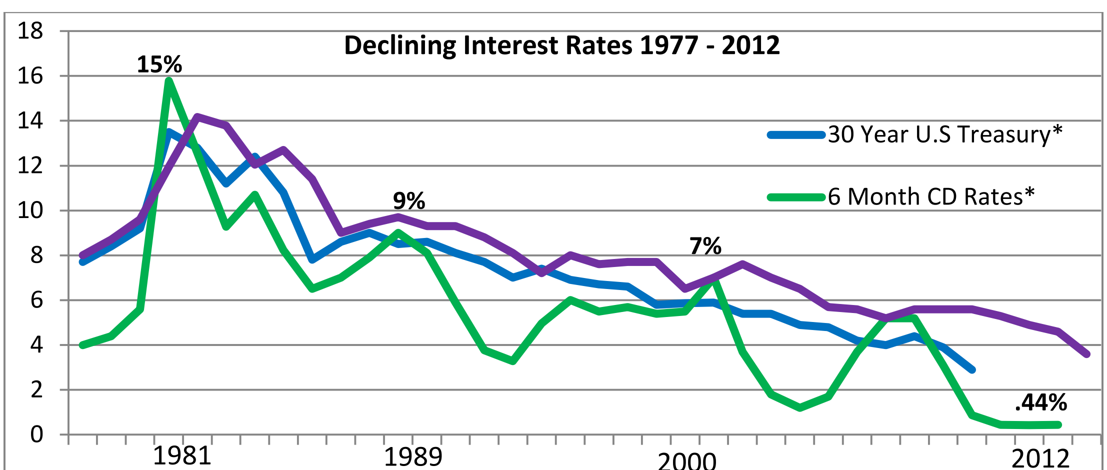


$1,000,000 Universal Life Policy
Male, age 57
Issue date 07/2009

Understanding that the Cost of Insurance charge is increasing annually as you age, how can your premium remain level? It is *projected* to remain level because in the early years the insurance company charges more than necessary to cover expenses. This excess premium earns a *projected* interest rate and builds cash values, thereby establishing a reserve from which policy expenses are paid when the premium is insufficient to do so.

<u>Declining Interest Rates</u>

The second critical component to a policy's projected performance is the interest crediting rate assumption. The interest rate generally used is the prevailing interest rate at the time of policy purchase. For example, if you purchased a policy in the early 1980's it was common to use an interest crediting assumption of 10% - 12% and further assume that it continued at that level for the life of the policy. Of course, we all know, as noted in the below chart, interest rates and therefore policy crediting rates have steadily declined since they peaked in about 1981.



*Sources:
Board of Governors Federal Reserve System
Mortality Rates: Male, age 45; actual projected costs of major insurer

Due to this combination of declining interest rates and increasing mortality costs it is fair to state that no Universal Life policy purchased between 1975 and 2005 has performed as it was intended much less as it was illustrated. For many, even if each and every premium has been paid when due, it quite possibly will expire worthless before the insured dies.

The reasons are simple.

- Interest rates have been declining for thirty years. Therefore, actual Universal Life interest rate earnings have been meaningfully less than originally projected.

- With Non-Guaranteed Universal Life, insurers have the right to increase the current charges up to a maximum guaranteed level. Many have increased charges due to the lower interest rate environment, or simply to maintain profit margins. The result is projected policy expenses in Universal Life policies have likely been greater than originally projected.
- Given declining interest rates and increasing expenses, premium levels were much less than adequate to build sufficient cash value reserves.

__Case Study__

Let's review an example of a $1,000,000 Universal Life policy issued on Jack, a 45 year old male.

When Jack purchased his policy, the original illustration assumed a 7% interest crediting rate. His annual premium was $7,337. At this level of premium and interest earnings, the policy is projected to remain in-force to age 100. But what if it earns 5% instead of 7%? At 5%, the policy lapses at age 86 and coverage terminates unless Jack deposits additional premium. At 5% versus 7% interest earnings and projected charges, the additional annual premium required to continue the policy to age 100 is now $68,232.

Alternatively, what happens if Jack earns 7% but charges are increased to their maximum? In this case, the policy will expire worthless at age 65 without additional premium. Even if the policy earns 10% annually, the policy will still expire at age 65 because the guaranteed charges are so much higher than projected non-guaranteed charges. It is worth noting, should this occur, it is not possible for Jack to deposit sufficient premiums to continue the policy to age 100.

__Non-Guaranteed versus Guaranteed Policy Expenses__

With all non-guaranteed policies, on-going annual or monthly policy expenses and interest earnings are merely assumptions. Ultimately, it is the actual expenses and interest earnings that determine the performance of the policy. If the actual experience falls short of the assumptions, it may have a serious impact on the policy over time.

Note that while the original illustrated performance is based upon projected non-guaranteed expenses and interest, there is a guarantee as to the maximum expense that that can be levied by an insurer. The gap between the non-guaranteed projected expense and guaranteed maximum expense is significant. Should the insurer choose to increase policy expenses above the original projections, depending upon the degree, it will may a devastating impact upon the policy.

Some carriers, including the one in this example, disclose the non-guaranteed versus the guaranteed charges. In this case, the projected total of non-guaranteed charges at the end of ten years is $41,262. After twenty years the total is $82,305. Compare this to the maximum charges the carrier is permitted to charge. At the end of ten years they total $149,086 versus $41,262 projected and at the end of twenty years $354,481 versus $82,305 projected, a 330% increase.

Consumer and Agent Awareness

The last problem is an absence of consumer and agent education. Gone are the days of purchasing a life insurance policy and simply placing it in the safe deposit box until death occurs.

In all situations, the consumer or his insurance agent can request periodic in-force policy reprojections from the insurer. These re-projections will reveal the actual performance of the policy versus the original projected policy performance. Re-projections also include future performance projections based upon current interest rates and newly projected expenses. This annual practice can help anticipate potential problems and identify what actions are require get the policy back on track.

In reality, most agents are unaware of the explosive impact that occurs when a non-guaranteed policy experiences a combination of progressively extended declining interest rates, coupled with increasing costs of insurance. In their defense, the problem did not exist in the past. Never have we had this extended period of declining interest rates coupled with increasing policy costs. Most life insurance companies are also unprepared as their communication is limited to sending a letter to the policy owner informing them that the policy is about to terminate unless more premiums are paid.

Potential Solutions

Fortunately, there are usually solutions. One can…

- Add extra money to maintain the current death benefit.
- Reduce the face amount which lowers the Cost of Insurance.
- Some combination of the above.
- Exchange the policy for a new one with lifetime guarantees if health permits.
- Possibly sell the policy.

The first step in knowing which solution is best is to request the insurance carrier provide a current in-force re-projection of his policy. This will provide a new baseline, and reveal what problems and risks may be present. It will also reveal how the policy has performed thus far and how it is projected to perform in the future based upon the current interest rate and projected current expenses. Jack will then be in a position to compare potential solutions.

It is worth noting that the thought of replacing a policy often runs contrary to the conventional wisdom of "it is almost always better to keep what you have than to make any changes." That may have been true in the past but quite often a problem policy can be "rescued" by replacing it with an updated policy that is fully guaranteed. However, an existing policy should never be terminated until a more favorable one has been issued, accepted by the policyowner and placed in force.

In summary, while non-guaranteed life insurance , be it Universal Life, Variable Life or Index Universal Life, is considered "permanent" insurance, it can actually expire well before life expectancy due to lower interest rates, a falling stock market, increased charges by the carrier or some combination of those factors. The payment of your premium will not guarantee that your policy will remain in-force.

About BDLife212°, LLC and the Author of This Paper

BDLife212°, LLC is an independently owned organization specializing in providing life insurance expertise to Investment Advisors and Wealth managers. It's President, Don Ward, is the author of this white paper. He is uniquely qualified to address the subject as his career in life insurance includes twenty years as a private practitioner and twenty years as a senior executive with two major life insurance carriers.

For More Information

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