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Low interest rates threaten universal life insurance policies

Policies sold in the '80s and '90s are at risk of lapsing, causing problems for clients and advisers

By Darla Mercado

Low interest rates are imperiling in-force universal life insurance policies, and consequently pose a potential threat to trusts and estates.

Attorneys, accountants and financial advisers are struggling with universal life insurance policies that were written during periods of higher interest rates for use within an irrevocable life insurance trust to help soften the blow of estate taxes.

These days, those policies – which were sold in the 1980s and '90s – are at risk of lapsing, and clients will have to make the choice between letting the policy go, taking a cut in death benefits or shelling out even more money to fund premiums and keep the policy in force.

"Back in the day when the estate planning attorneys drafted these trusts, many of them also became the trustees," said Thomas J. Henske, a partner at Lenox Advisors. "They didn't think of the life insurance [inside] as an investment, but rather as something they could set and forget. These policies are now set to fail and the price for remediation is enormous."

The cost of failing to keep up with an insurance policy are very real. One of Mr. Henske's clients bought a policy from an agent when he was 40 and was told he would be paying premiums of $12,000 a year for $4 million of coverage. At the time, the interest paid on the policy was 6.25%. When Mr. Henske reviewed the policy six years later, the credited interest rate had come down to 4%, and now the client will need to pay up $25,000 per year to keep the policy.

"This is problematic: He budgeted for $12,000, and now he's literally paying double that amount to keep it in force," said Mr. Henske. "If we hadn't audited the policy, it would've been even more. If you catch it early, you have a better chance of beating it."

This client wound up keeping the policy at the higher premium.

The problem is that these policies were based

Henry Montag

on optimistic interest rate assumptions, back when those rates were as high as 15%. So-called UL features included not only a death benefit, but also a cash value account that receives interest and that can be funded by a portion of premium dollars. Costs of insurance are drawn from the cash value.

Upbeat interest rate projections at the time meant that clients being sold these policies did not expect to pay much to fund the policy's costs. Those high credited interest rates supposedly would help foot the bill.

"Even the most conservative agents and brokers were projecting 7% to 10% [long-term] interest rates," noted Henry Montag, a partner at Financial Forums Inc., who has been discussing the issue with a number of estate planners.

But in today's low interest rate environment, it's become significantly harder for insurers to credit the rates clients were expecting 20 years ago. Now, those customers need to cough up more money to fund the cost of keeping the policy in force. If they can't, they have the option of lapsing or cutting their death benefits. Even charitable giving plans that intend to donate UL death benefits to causes have also been dinged by the development.

Mr. Montag estimates that many of the trustees overseeing the affected trusts also are relatives of the person who set up the vehicle in the first place. "They accepted the position without any knowledge of their responsibilities, duties and liabilities, nor do they have the skills necessary to successfully keep the trust's primary holding — its life insurance — from expiring prematurely," he said.

In fact, those trustees run the risk of violating the fiduciary duty they owe the trust if the insurance policy fails, according to an Oct. 17 newsletter from the Association for Advanced Life Underwriting.

There's a lesson here for financial advisers and trustees: Treat life insurance as an asset that will require a periodic check-up to ensure that it's holding up in today's environment. Randy Whitelaw, managing director of Trust Asset Consultants and co-creator of The TOLI Center, a life insurance risk management services provider, uses a framework that not only employs an investment policy statement but also ponders the suitability of a given policy for a trust.

"If it's determined that it's suitable, you want to ensure that there is a credible evaluation to determine the premium amount necessary to be paid to sustain the policy," he said.

As for policies that are already in crisis, advisers should evaluate whether the client can reasonably reduce the policy's death benefit. "Many of these were bought when the estate tax exemption was far below what we have today [now at $5.25 million for individuals]," said Gavin Morrissey, senior vice president of wealth management at Commonwealth Financial Network.

Still, "there may be cases where they need the liquidity, say for state-level estate taxes or if it's part of a buy-sell agreement or for succession planning," he added.

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