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What the Non-Insurance Advisor Needs to Understand About Indexed Universal Life Insurance

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In our experience, the professional advisor community isn't always enamored with the idea of diving into the details of life insurance. In fact, we often see advisors holding their tongues even when life insurance will be a substantive aspect of a business succession or estate plan. There can be a number of reasons but the most common is because they don't know what questions to ask (or what to do with the answers if they do).

We feel strongly that advisors need to have a better working understanding of life insurance in order to be more fully engaged with the process as well as to recognize potential problems for themselves as well as their clients. We'll focus on Indexed Universal Life (IUL) for this article because it is a very popular product and is more complicated than most people understand.

The most simplistic explanation of IUL is that it is a version of universal life but, rather than having a stated interest rate like traditional UL or guaranteed premium and death benefit similar to guaranteed UL or investment sub accounts like variable UL, IUL is classified as a fixed product with crediting linked to an index, most commonly the S&P 500 Index. It is postured as a product with upside potential without the downside risk. For example, the crediting of cash value in an IUL product may have a cap of 10% with a floor of 0%. This means that when the Index is up 10% or more, the policy crediting is only 10%. However, when the Index is negative, the policy is credited with 0% and the client won't lose any money as a result of the negative return. When the return is between the two, the policy is credited with that return.

Upside potential, downside safety — you can't lose. If only it were so. The purpose of this piece is not to bash IUL. As we are fond of saying, "It's not as much bad insurance as it is insurance done badly." Whether you are ultimately a fan or not, it's difficult to argue that an advisor or client shouldn't be better able to understand the mechanics of such a product. While there are many rabbit holes we could go down and endless technical analysis, we intend to explain this in as simple a manner as possible.

A LITTLE HISTORY

It may prove beneficial to learn how we got here. Until the late 1970s there was just term and whole life. These were both fixed-premium products with guarantees. In the late '70s and early '80s, when interest rates kept increasing, money was continuously being withdrawn from the cash value of life insurance policies, which were earning 3–4%, to be deposited into money market funds and CD's at banks which were paying upwards of 15–16%. In the early 1980s, in an effort to stop these tremendous outflows, well-respected investment firm E.F. Hutton took matters into their own hands and created a new type of life insurance product that would be competitive with the crediting of CD's and money market funds. They called it universal life insurance, and people no longer had to leave the life insurance industry to earn a competitive rate of return on their money. As a result of the increased interest rates the projected cost of universal life insurance had significantly decreased and within two years 40% of the life insurance companies in the nation had a universal life type product. Universal life insurance was a "new money" product as opposed to a portfolio rate product like traditional whole life. Of course, this made whole life look rather stodgy, resulting in an exodus from whole life insurance to universal life.

In the late '80s, 30–40% of new insurance purchased was universal life. But, unlike its predecessors (term and whole life), universal life insurance was not guaranteed. This meant that if interest rates decreased, insured persons should have increased their future

premiums payments to make up for the reduced earnings in order to maintain the initial duration of their coverage. While the life insurance industry solved its short-term problems, a far greater problem was born for the consumers as interest rates continued to drop to where they are today, 3%. Life insurance went from a buy-and-hold asset to a buy-and-manage asset but, unfortunately, the great majority of individuals purchasing these non-guaranteed universal products were not aware that they needed to actively manage their life insurance policies, just as they would their stock and bond or real estate portfolio. Many of them today are finding their life insurance coverage expiring years earlier than anticipated.

CREDITING RATES AND GUARANTEES

Just as the stock market was booming, variable universal life made its appearance in an attempt to chase the high crediting rates that went with it. This peaked in the late 1990s, when blind monkeys throwing darts could get 20% returns. The dot com crash put an end to this.

The first guaranteed UL products were introduced in the early 2000s. Policy owners were tired of losing value in their policies so the industry introduced a guaranteed premium and death benefit product that seemed to have no moving parts. The sales of these products soared. Ultimately, between some regulatory changes and the fact that insurance companies couldn't make money in the ultra-low-interest markets, these products were pulled or had premiums increased for new sales.

At that point, universal life and whole life insurance products had decreasing crediting rates, the market was scared of the volatility of variable universal life due to stock market exposure, and guaranteed UL products weren't as cheap. So something new was needed. Indexed universal life insurance was a perfect fit. Here we had a flexible-premium product offering meaningful cash values and exposure to the stock market for the upside potential without the possibility of losing principal in a down market, all obtainable with reasonably long guarantees at competitive premiums based on projected policy crediting. It was a win/win/win — and it took off.

Before we continue, we'd like to make an observation. Over the past number of decades, the one constant in life insurance sales is that the product with the lowest premium or the highest cash value and/or death benefit is the most attractive to the consumer and therefore the easiest to sell and is therefore pushed by carriers and distributors.

Such manner of transacting life insurance is dangerous because, unlike traditional investments, life insurance is generally an asset that is held for the long term. But we see decisions being made due to momentary market conditions and sales strategies for products that will last for the balance of an individual's life and often without the ability to be changed. Think about it. Many agents selling variable universal life in the late nineties were assuming 10–12% returns indefinitely, keeping cash values in growth and aggressive growth sub accounts even when insured individuals were in their eighties and nineties.

HOW THEY WORK

With an IUL product it is important to remember that the premium dollars are not being put into the chosen index. Options are purchased to support the crediting parameters of the products. Some very smart people believe that the long-term reasonable performance of IUL products is much closer to that of regular UL products than the market would have us believe. However, most IUL products are sold on an expectation that they will substantially outperform traditional fixed products by 50% or more despite the counter-intuitiveness of projecting such returns without commensurate extra risk. Let's remember that these are fixed products and none of the premium is being invested in securities so illustrations showing dramatically higher returns indefinitely should be closely scrutinized.

A number of years ago, a new regulation, Actuarial Guideline 49 (AG49), was implemented because IUL ledgers were showing ridiculously high assumed rates of return that, depending on how a policy was constructed, showed very low premiums or very high death benefits and cash values — a ''beauty contest'' with numbers.

There are more than a few who feel the new regulations still allow overly optimistic projections. Also, these regulations are not well understood by the agents selling the policies nor the consumers buying them. In fact, many sales ledgers are run at the maximum allowable crediting rates.

While the regulations are built from many years of historical market return data, there is, in reality, very little in terms of historical IUL data. But if IUL crediting is based off of market returns, how could that be? The regulations for current produced ledgers assume the product cap of the moment. The caps are driven by factors such as market volatility that drives options pricing. These caps have come down meaningfully over recent years and when they do, all of the calculations of rolling averages the past decades change as well because the caps are a meaningful aspect of the formula. We simply don't have that many years of historical IUL returns because IUL hasn't been around for that many years and much of the data we have is based on a historical bull market.

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THE PROBLEM

Let's look more closely at these sales ledgers that purport to project performance. It's commonly understood and legally appropriate to realize that projections will not come to pass. Statistically, they cannot. They aren't even supposed to be used to compare policies against each other. However, consumers commonly make decisions based on these ledgers and expect them to pan out as shown. The problem is, anything other than guaranteed products are little more than shots in the dark. This doesn't make them inappropriate but does mean they need to be thoroughly understood.

Many things will affect future performance. Just one thing is sequencing of returns. Everyone knows that even if a projection assumes 6.5% every year on a level basis indefinitely, that is not how the markets will work. They will definitely go up and down. What many people do not understand is that the order of return makes a big difference. A 10%, 0%, 5% sequence doesn't work like a 0%, 10%, 5% sequence. In other words, the manner in which the market, and subsequently a policy, will perform cannot be modeled by the agent and insurance carrier selling the product. The regulations meant to protect the policy owner often effectively allow projections that are far from reality.

Just because sequencing of returns can't be incorporated into policy projections doesn't mean policies can't be subjected to stress testing and independent modeling. In fact, this is exceedingly important to do and can be illuminating. Since too many sales are based on spread sheeting to beat the competition, there's an incentive to use high assumed crediting rates and minimally fund policies because this shows a lower premium and lower premiums are too often presumed to be better. After all, why pay more than necessary? This is probably one of the most dangerous mindsets when evaluating non-guaranteed, current-assumption life insurance products. Testing and modeling can expose the inherent weakness of many proposals by showing the chance of a policy failing when real world conditions are applied. In fact, the smallest changes in assumptions can cause a proposal that looks great to fall apart completely. The results can be shocking, and no prospective IUL policy owner should move forward without this type of stress testing at alternate interest rates.

Focusing on the six-point-something maximum return common in policy projections today, may seem to consumers to be very conservative because the S&P 500, after all, has returned double digits over the long term. Over the past decade, the return has been greater than 13%, over the past 40 years it's been over 11%, and over the past 100 years better than 10%. My experience is these numbers ring true to many people. So 6% is clearly conservative. Or is it? The S&P 500 returned less than 6% over the past 20 years so it matters greatly what period you're looking at. But there's more to it than that.

THE S&P 500 RELATIVE TO THE S&P INDEX

Of the past 10 decades, only half had total returns in the double digits, with two full decades experiencing a negative return. But this isn't the most important thing to understand. More important is what the S&P 500 Index actually is. Few people understand that the S&P 500 stocks and S&P 500 Index aren't the same thing. The S&P 500 Index doesn't incorporate dividends in its return numbers. Does that make much of a difference?

With the exception of the past decade of a historical bull market, there is no long-term back testing where the S&P 500 Index is double digits. In fact, over the past 20 years it's less than 4% and over 100 years it doesn't quite hit 6%. There are entire decades in which over half of the return is due to the dividends. If these are the S&P 500 numbers that indexed policies are actually built from, how should that affect decision making?

Policies focused on cash value and supplemental income clearly need to be built in a particular way to maximize cash accumulation. IUL policies are often used for supplemental retirement income plans because they can show attractive income scenarios. In fact, the income projected to be available may be multiples of that of a whole life or regular UL policy. However, wiser people understand that significantly more attractive projections are made possible because they are less likely to materialize. Furthermore, these income scenarios often rely on policy loans, and there are a variety of loan options and features that can quickly become complicated, but decisions need to be made with ongoing policy management assured. Some of these options involve risk policy owners don't realize or understand. Poor decisions can magnify over the decades a policy might be in force.

IN SUMMARY

As we wrap up, let's focus again on some basics. Potential policy owners often need some help with selection, structuring and ongoing management of any life insurance product but IUL policies have unique challenges. First, the ''You can't lose'' pitch sounds attractive but isn't really true. Many an IUL policy will go down in flames over time with the cumulative premiums and the death benefit gone up in smoke. ''But how is that possible if my base is 0%?'' Expenses. If you're promised a floor of 0% but your ex-

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penses are even a dollar, you're going to go backwards, aren't you? The policy costs, commissions, carrier overhead expenses, and costs of insurance add up, and a certain positive return needs to be realized to just tread water. The mortality costs in a policy can be massive when the insured individual is 90 years old. There are ledgers that show hundreds of thousands or even millions of dollars of cash value declines in later years when mortality costs rise and the policy isn't sufficiently funded. There could come a point where even if a contract was credited with 10% annually, it couldn't stay ahead of policy costs. To make it more maddening, a $10,000,000 policy could have a million dollars of internal expenses or very little at the same point in time, depending on how it was built and managed. Is there a policy owner out there who understands this?

All this isn't to say that IUL shouldn't be on the menu, but there is more to it than most people realize and it's not for the consumer who takes at face value what an agent tells him. Even the new ''Best Interest'' rules, which will first become effective in February 2020, will not account for much of what we are discussing here. If the consumer doesn't know the right questions to ask — and the great majority don't — it's in their best interest to work with an independent insurance consultant who has their ''Best Interest'' in mind not because of a rule, but because it's always been the right thing to do as a professional. These insurance products can be utilized very effectively for a variety of death benefit, cash value, and supplemental income purposes. Additionally, many IUL products also have a menu of features and riders that can be effectively utilized. Accelerated death benefits, the ability to pay for long-term care costs and critical care riders are among the features a consumer can evaluate in choosing the most appropriate product.

As we said earlier, it isn't as much that there is bad insurance as there is insurance done badly. In a skilled and responsible practitioner's hands, we believe, IUL can have a place in building clients' policies. But the very reason we have written this article is because we've seen too much insurance done badly. ''Let the buyer beware'' is sound advice today as ever, and as an advisor you can bring tremendous value to your own portfolio as well as to your clients by knowing the right questions to ask.

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