# The Saga Continues for Universal Life Policies

Universal Life came into being in the late 70's. What was happening in the late 70's? Need I remind you of the lines at the gas stations or that short term interest rates were at 20%? An inverted yield curve ignited the creativity of insurance company actuaries. Whole life, the longtime stalwart of the permanent life insurance market was getting clobbered by low long term interest rates and the insurance companies were having a run on "the bank", their general account was being decimated by consumers requesting loans so they could invest the money at 20%. The arbitrage opportunity was huge but it left many whole life compromised because loans and interest are most all the time rolled up into the policy annually jeopardizing their long term viability. As I come across these old policies with large loans the owners tell me they had no idea the effect this would have on their policies.

What did the insurance companies do? They came up with two ideas. One was "direct recognition" dividend scales on whole life policies which we will save for another newsletter. The second was a NEW innovative policy structure, invented by E. F. Hutton Life. Now mind you, up until 1977 there had never been another type of permanent life insurance other than whole life and annual increasing term life insurance!

So what was this NEW life insurance called Universal Life all about? Here are a few of the changes:

- They unbundled the product components and striped the policy of all its guarantees allowing for more flexibility of premium funding which also is a major risk in this policy structure as they were generally misunderstood
- They built the structure so the consumer took all the investment risk; the consumer wanted some of that 20% return!
- Instead of guaranteed mortality and expense factors found in whole life they built the policy with annual increasing costs of insurance which they have the right to increase or decrease and an expense factor that may also change
- As long as there was cash value in the policy and it was large enough to pay the current costs of the policy you had total flexibility in whether you paid any premiums or not
- The policy cash values were invested in these high short term interest rate instruments. This allowed the insurance companies to illustrate much higher returns therefore allowing them to show much lower premiums.
- The bottom line: more flexibility, significantly more risk

Do you think the consumer understood that if interest rates were to decrease that the earnings on the cash value + the premium may not be large enough to fund the future increasing costs of the insurance?

Bernanke just announced that short term rates will be kept low for the foreseeable future so even Universal life policies sold within the last few years could be in jeopardy! Most Universal Life policies sold in the since the invention of Universal life are failing to some degree. The NEW market conditions make it very difficult for them to perform based on the original expectations of the buyer.

The Efficient Edge ◆ 120 S. LaSalle ◆ Suite 1710 ◆ Chicago IL ◆ 60603 ◆ P: 312.368.7560 ◆ peter.steger@efficientedge.net
Peter F. Steger CLU, ChFC, REBC – Principal, The Efficient Edge

The problems I have encountered with Universal Life:

- If the client has waited too long to address the funding issues then the additional premium needed to fund the same death benefit will be significant
- Life insurance policies can only accept so many premiums as defined by the government.  There has been cases where the additional premium needed to fund the current death benefit cannot be deposited because it will violate the maximum premium rules
- In other cases we have had to decrease the death benefit because the client either does not want to fund the additional premium or cash flow is poor.  The decrease in death benefit is so severe that it is better to take the cash value and invest it depending on the life expectancy of the insured.
- Annual statements showed increasing cash values even as interest rates declined but if the consumer was shown the projections at these lower interest rates they would have found that later in the life of the policy the increasing cost of insurance would eventually absorb all the cash value and the policy would lapse!

Another issue with the current low interest rate environment is that the insurance company reserves the right to increase cost of insurance charges and/or other expense factors.  With that said, beware of rating agency changes.  If a rating agency downgrades a rating on an insurance company it is due to their assessment of a decline in profitability or a deterioration of reserves which may cause them to increase the charges in certain blocks of universal life policies.  High and stable ratings for financial strength and claims-paying ability are relevant to the overall suitability of the life insurance program.

Universal Life policies will continue to be under extreme pressure as low interest crediting rates will not allow the current funding, in many cases, to support the long term death benefit structure.