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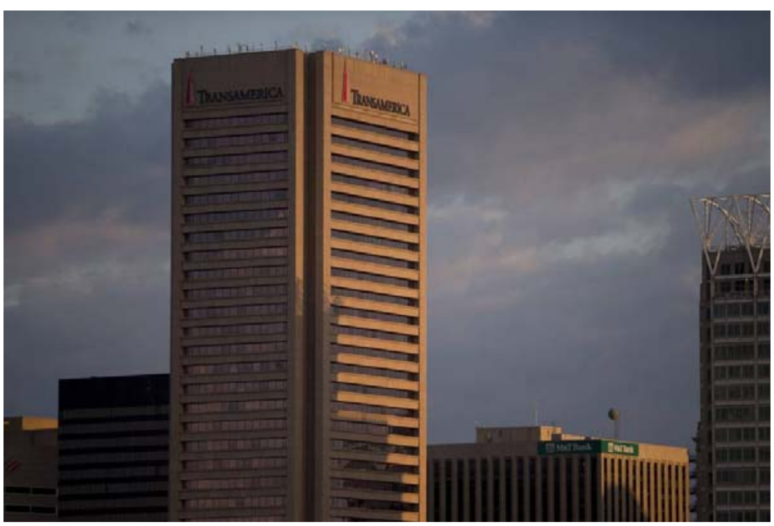
http://www.wsj.com/articles/why-old-life-insurance-policies-are-now-getting-a-surprising-price-increase-1472754636

MARKETS

Life Insurance Customers Push Back Over Surprise Cost Increases

Policyholders are filing suit, as big U.S. life insurers blame the Federal Reserve's decision to keep interest rates lower for longer



Several big insurers have notified thousands of customers of higher costs to keep their policies in force, with increases ranging from midsingle-digit percentages to more than 200%. Shown, the Transamerica Tower in Baltimore. *PHOTO: ANDREW HARRER/BLOOMBERG NEWS*

By LESLIE SCISM

Updated Sept. 1, 2016 5:30 p.m. ET

Americans are starting to fight back against a wave of insurance-price increases on decades-old life policies.

Over the past year, several major insurers have notified tens of thousands of people of higher costs to keep their policies in force, with increases ranging from midsingle-digit percentages to more than 200%, according to financial advisers. To justify the increases, they blamed the impact on their investments from the Federal Reserve's decision to keep interest rates lower for longer.

At least a half-dozen lawsuits have been filed in federal courts against insurers including Aegon NV's Transamerica unit and Legal & General Group PLC's Banner Life.

In many of the suits, which seek class-action status and damages, the plaintiffs contend insurance firms are hiding behind little-used contract provisions to rummage up cash for shareholder dividends. They also argue that increased lifespans have offset the negative impact on profits of lower bond yields.

The insurers counter that these cost increases are permitted under provisions that allow them to charge up to a maximum amount, based on expectations of future policy performance. The insurers claim those expectations have plummeted with the Fed keeping short-term interest rates at near zero for nearly eight consecutive years.

Fed Chairwoman Janet Yellen signaled last week that the central bank could possibly start to raise rates this month, but many analysts don't see rates increasing meaningfully enough soon to change the situation for insurers.

"Companies are under a lot of pressure to boost returns in this low-interest-rate environment, and this is one lever they have," said Scott Robinson, an associate managing director at Moody's Investors Service. "Companies have to weigh the right they may have versus what impact it might have on their reputation in the marketplace with the various parties."

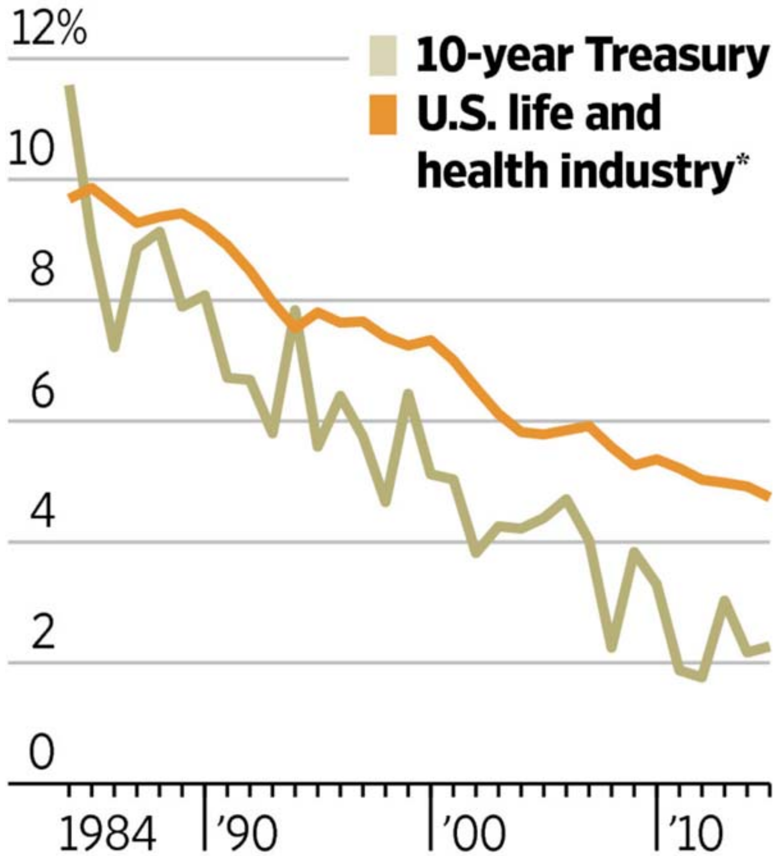
Among upset policyholders is Raymond Foos, an 87-year-old retired manufacturing chief executive who purchased an $11 million policy in 2003 to benefit his children. This spring, Transamerica informed him of an increase that he said will cost him nearly $300,000 a year, on top of the $2.25 million he paid as a lump sum to buy the policy and which he thought would cover costs through his and his wife's death.

Mr. Foos, who said he is exploring legal action, regrets not asking enough questions about risks when he bought the policy.

Sliding

A decline in bond yields has put significant pressure on insurers' "universal life" policies.

Yields



*Net yield of investment portfolios of total U.S. life and health industries
Sources: A.M. Best (insurance); Ryan ALM (Treasury)
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He said Transamerica should "bite the bullet." Drawing from his years of running a business, he said, "when you have a sale that you lose money on, you don't go to the customer and say, 'Give me some more money.' You generally figure out how to live with your problem and go on....You tighten your belt."

Speaking generally, a Transamerica spokesman said the insurer's increases leave costs "at or below the maximum rates allowable" by contract.

Life insurers have been among the companies hardest hit by the Fed's policies, which have been mirrored by many central banks around the world. These firms earn much of their profit by investing customers' premiums in bonds until claims come due. Shares of big U.S. life insurers have dropped 5.4% since the start of 2008 through Wednesday, according to the S&P Composite 1500 Life & Health Insurance Index, compared with a 48% gain for the S&P 500.

At issue are "universal life" policies. In short, the policies combine a death benefit with a tax-advantaged savings account that has a minimum interest rate. Such policies accounted for more than a quarter of all individual life-insurance sales in some years past. Millions of Americans own them.

Insurers' problem is that many older policies guarantee annual interest rates of 4% to 5%. In the mid-1980s, when universal life policies surged in popularity, the average investment portfolio yield for life insurers was nearly 10%, according to ratings firm A.M. Best Co.

Today, that yield is just under 5%, thanks to a general decline in rates over the decades, followed by the more recent sharp leg down.

In selling universal life, insurers typically aim to earn 1 to 2 percentage points more on the premiums they invest than they pay out in interest to policyholders, said Deloitte Consulting LLP principal Matthew Clark. Most insurers aren't earning this spread today, and "with continued low rates some could face a situation where they are paying out more to policyholders than their investments earn," he said.

The lawsuits argue the policies are profitable enough even with shrunken investment yields. They also contend the insurance industry is raising rates to force consumers to cancel policies, thus reducing insurers' future payouts.

Of the triple-digit-percentage increases, W. Daniel "Dee" Miles, a lawyer suing Banner, said "there is no way they could have missed the mark that bad."

In court filings, Banner asserts that plaintiffs' lawyers are using "entirely unrelated legal controversies...to muddy the waters in a relatively straightforward case."

Also at issue in the lawsuits is "mortality" experience. In setting initial policy charges, actuaries make assumptions about the life expectancy of people who will buy the policies. The lawsuits maintain that the insurers have profited from rising life expectancies across the U.S. population, and that is among reasons they said cost increases shouldn't be allowed.

In general, if an insurer ends up with customers who live longer than its actuaries anticipated, it can earn bigger profits because it collects more years of premium than anticipated before having to pay death benefits.

Between the investment shortfalls and better-than-expected life expectancies, “the policies are still profitable” on an industrywide basis, said McKinsey & Co. senior partner Giambattista Taglioni. But experience varies across companies. “Some blocks of business are already underwater, and some others have reduced profitability but are still profitable.”

At least two cost-increase cases involving universal life were settled out of court in recent years, said James S. Bainbridge, an attorney who follows litigation for the Association for Advanced Life Underwriting, a lobbying group for insurance professionals.

Write to Leslie Scism at leslie.scism@wsj.com

From: Al Gibbons
Sent: Wednesday, December 16, 2015 10:49 AM
Subject: The Problem with Universal Life

As far back as November, 2012 there was a *WSJ* article entitled, "Draining Away!" You will see in a moment why I think that title is so important. The most recent article in the *WSJ* by the same author is, "Surprise: Your Life Insurance Rates Are Going Up" and there is a new article in *InvestmentNews*, "Universal Life Cost Increases Could Be 'Tip of Iceberg.'" For the last 30 years, steadily declining interest rates have been wreaking havoc on universal life policies and the insurers who issued those policies. In the early 80's, 10-year treasuries topped-out at 15% and today yield less than 2.5%. That decline is devastating for interest-dependent performance in universal life policies.

Let me explain the problem clearly and concisely; and, then, show you the *next step* that insurers are taking to protect their profits. Please view the "Bucket" attachment. I have used the "Bucket" to demonstrate how universal life works since I first started recommending it in the early 1980's. The first step is to determine how much money (premium) is required to pour into the top of the bucket to carry the coverage to age 100 using *current assumptions*. The crediting interest rate in the early 80's was 12%; so, assuming that 12% would be credited to the accumulating funds starting immediately and lasting forever, the client would have a required premium of $X. However, here is the rub – it's not the premium that pays the *current* charges being *drained* from the bucket, it is the accumulated cash value in the bucket that pays the *current* charges each month. If the cash value doesn't grow at 12% (declining over the years to 10%, 8%, 6%, 4%, to minimum *guaranteed*), sooner or later the cash value in the policy will *drain away*; and there won't be enough money in the bucket to pay the charges. The client will have to add money to the bucket or the policy will lapse. So, it's pretty easy to see what has transpired with these policies. If the agents who sold the policies did not do annual reviews with their clients and explain the ultimate results of declining interest crediting rates, their clients are in for a big surprise today.

Unfortunately, that's not the end of the story. Interest rates have been at historically low rates for an extended period of time. Some companies have taken the *next step* to stem their losses. It is very important to understand the importance of *current vs. guaranteed maximum charges* and *current vs. guaranteed minimum credited interest rates.* So far, four companies (AXA, Banner, ING/VOYA, and Transamerica) have raised their "cost of insurance" charges (still below the *guaranteed* maximum) on certain blocks of business. The result – the cash value in the bucket is depleted even faster, meaning remedial action will have to be taken sooner or the policies will lapse.

The progression of *permanent* insurance since the early 80's – whole life, current assumption universal life, variable universal life, no-lapse guaranteed universal life, indexed universal life, and who knows what next. All of the universal life policies are in some way performance-based and can be viewed through the "bucket" prism – I think I can fairly safely say that all of them have underperformed their original illustrations. The exception is *No-Lapse Guaranteed Universal Life* (*NLGUL* - see attached Leimberg/Gibbons *Estate Planning* article for a detailed discussion of the topic). This product has been available since the early 2000's – all performance risk is assumed by the issuing life insurance company as long as the client pays the annual premium when due. NLGUL is, almost without exception, the only permanent coverage that I've recommended in trust-owned coverage for older, high net worth clients.

All whole life policies relying on dividend support and all non-guaranteed universal life policies should be reviewed promptly, then every two or three years going forward. All NLGUL policies should be monitored annually to make sure the premium is paid on time and the guarantees are in place as originally illustrated. If problems are discovered, remedies are available. Ignorance is not bliss.

P.S. With interest rates at historic lows, perhaps current assumption universal life policies are now worth a look with possible rising interest rates looming and potential results outperforming today's illustrations – especially, for younger clients and non-trust-owned policies.

Al.

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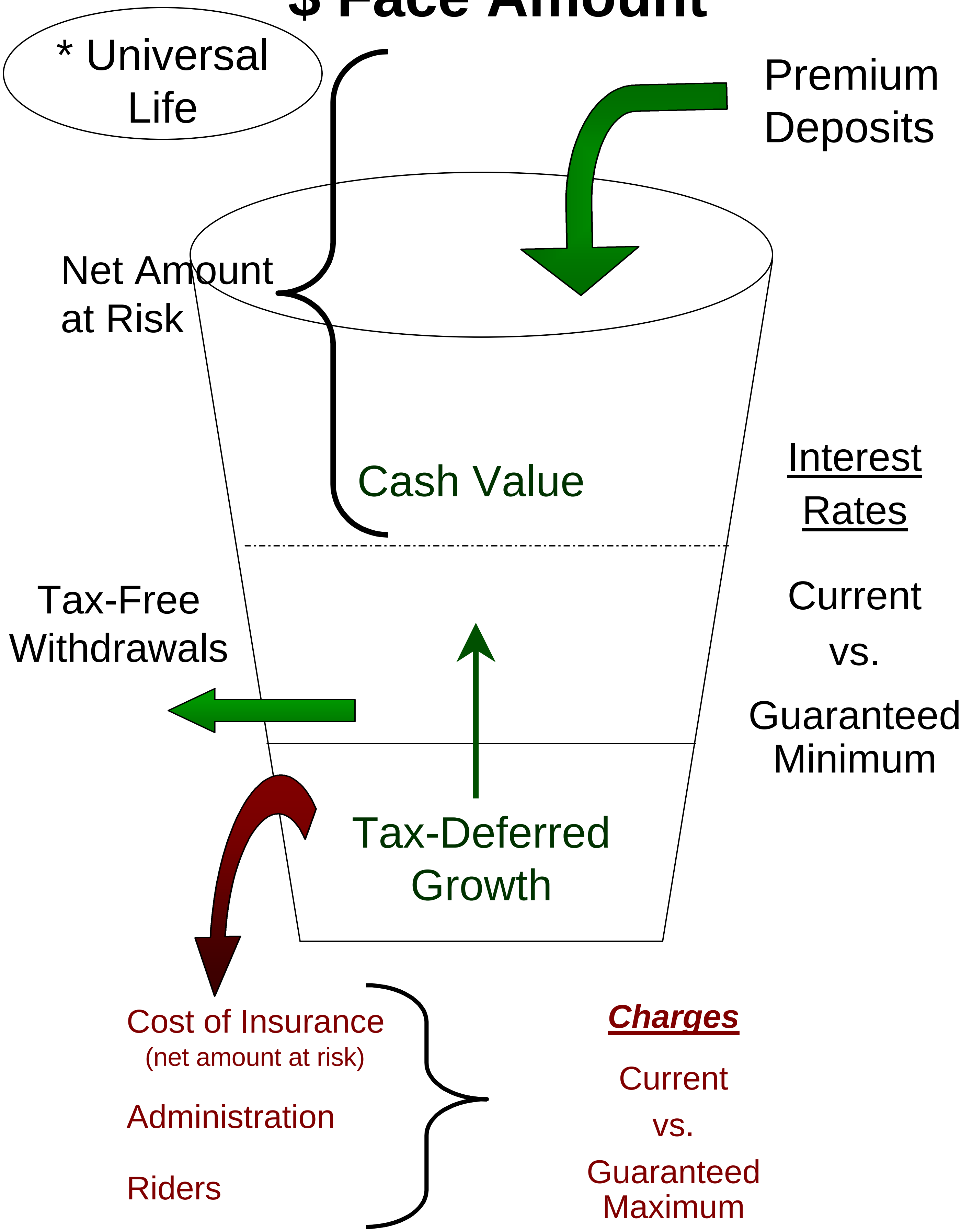
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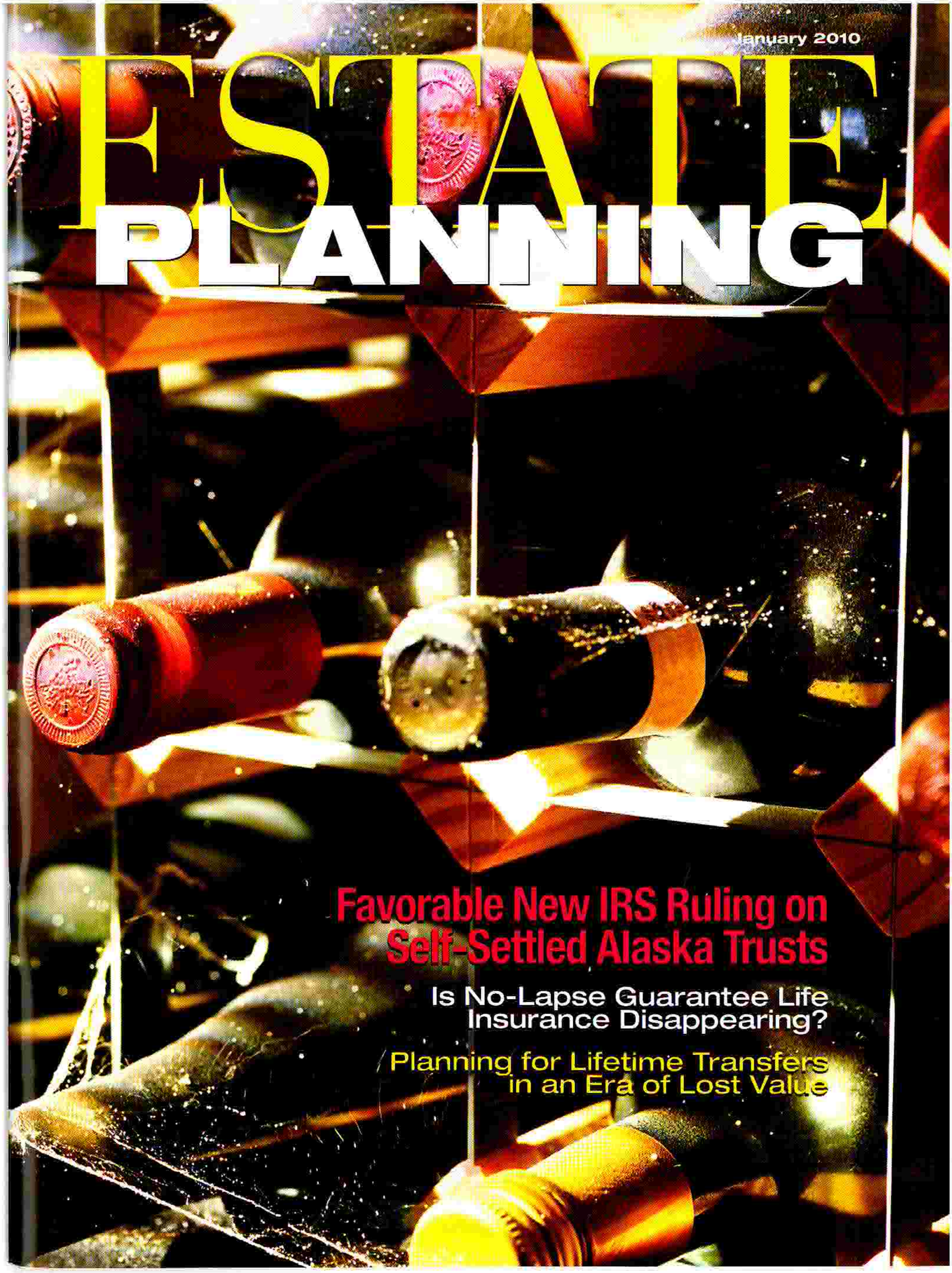

Favorable New IRS Ruling on Self-Settled Alaska Trusts

Is No-Lapse Guarantee Life Insurance Disappearing?

Planning for Lifetime Transfers in an Era of Lost Value

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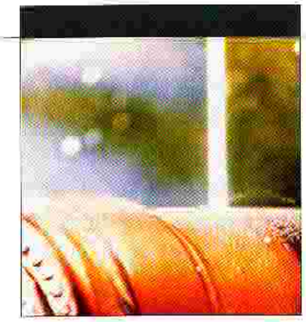

Are No-Lapse Guarantee Life Insurance Products Disappearing? Forever?

Long-term guaranteed products require the most reserves and exert the most pressure on an insurer's capital, so they are the products garnering the most scrutiny by insurance companies, and in the coming months and years are likely to experience the most change.

ALBERT E. GIBBONS, CLU, CHFC, AND STEPHAN R. LEIMBERG, ATTORNEY

Life insurance is almost always considered as part of every serious estate plan. What type (or types) of insurance is appropriate will, of course, be dependent on the client's goals, objectives, and circumstances, and upon underwriting considerations, cost of protection, cash flow sources and adequacy, and a number of other factors.[1]

In the past ten years, a type of coverage that features low cash values, guaranteed death benefits, and low premiums called "no-lapse guarantee universal life insurance"[2] has been, for many, a product of choice. The purpose and goal of this commentary is to examine the rise—and potential fall—of the use of this type of coverage in irrevocable life insurance trusts ("ILITs") for estate planning purposes, and assess its likely future.

He who forgets the lessons of the past

During the past 25 years, there has been a sea change in the design of life insurance products. (See sidebar on the different types.) It began with the relatively high premiums and inflexibility of guaranteed whole life ("WL") products, moved to the relatively low premiums and maximum flexibility of universal life ("UL") products in the very early 1980s. These unbundled, "current assumption" products were based on projections of high interest rates, improving low mortality, and aggressive assumptions regarding lapse rates. These assumptions resulted in "projected" premium requirements significantly lower than those required by the much more conservative whole life products—but in return shifted performance risk from the insurance company to the consumer.

Many insurance agents recommended replacement of in-force whole life policies with the then new universal life coverage. Based on projections, clients were told that they could have "vanishing premium" policies. For example,

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"Pay 10 years and your coverage—based on current assumptions—will continue to maturity." Then, it seems everything fell apart. Interest rates declined precipitously, policies significantly underperformed, and the projected "10 years" in the example above became 15 or 20 years—and the rest of the story is well-known.

Not content with the performance of these universal life policies, life insurance agents began leading their clients to "variable" universal life ("VUL") coverage—especially popular in the 1990s. The theory was that, perhaps, if interest rates were going to continue to decline, agents and their clients could depend on equity markets to provide 10%-12%+ returns—but with clients assuming even *more* investment risk. Again, based on those current assumptions, clients could pay less and get more. Then, it seems everything fell apart... *again*. Not only did clients *not* achieve a 10%-12%+ return; in the ten-year period ending 12/2008, the S&P actually had a *negative* return.

No-lapse guarantee products—pros and cons

After 20 years of underperformance and a disillusioned public, the life insurance community began to respond by once again going back to its roots and *accepting* risk—at a reasonable cost. So called "No-lapse, guarantee universal life products" ("NLGUL") started to appear.

NLGUL policies feature (relatively inexpensive) *permanent* death benefit guarantees—but at the *expense* of cash value performance.[3] Analytically, NLGUL policies typically offer very attractive internal rates of return ("IRR") on the guaranteed death benefit up to, and in some cases a bit past, life expectancy. (It was not uncommon in some years to see these death benefit IRRs approach, and even exceed, an after-tax rate of 7% even beyond life expectancy.[4])

Some argue that NLGUL policies should be considered essentially illiquid assets because it is unlikely that these contracts will have a cash value that is attractive for any other possible uses in the future due to the projected underperformance of the cash value. The lack of a significant cash value is clearly a major disadvantage if, at some time in the future, it is necessary or desirable to roll that cash value over into another new product innovation. Nevertheless, most who use NLGUL are willing to trade off and risk the policy's relative illiquidity in return for the greater certainty and security of shifting of permanent death benefit risk to the insurance carrier. Further, proponents argue that, in many cases involving trust-

(Text continues on page 18)

1 See Leimberg and Doyle, *Tools and Techniques of Life Insurance Planning* (National Underwriter Company, 2007) (800-543-0874) and Zaritsky and Leimberg, *Tax Planning With Life Insurance* (Thomson Reuters/RIA, 1995) (800-950-1216) for more specific guidance as to life insurance products and their taxation and use.

2 Malarkey and Leimberg, "Innovative Planning With 'No Lapse Guarantee' Life Insurance," 32 ETPL 3 (July 2005).

3 Some carriers are now offering NLG products that, in fact, have some significant cash value build-up—although it is not entirely clear to the authors how they are able to do this prudently at current premium levels.

4 WL and UL death benefit returns may be (or may not be, depending on the case) projected to be as favorable, but the illustrated WL and UL death benefit returns will assuredly carry the assumption of performance risk by the policy owner.

TYPES OF LIFE INSURANCE

Whole life ("WL"), as its name implies, is a contract designed to provide level death benefit coverage over the entire lifetime of the insured. It can be kept "permanently." It is the oldest and for many years the *only* form of cash value insurance ("CVI"). Whole life has had many names and variations over the years (e.g., adjustable WL, participating and nonparticipating WL, current assumption WL, modified and increasing premium WL). The form of WL that is most commonly available today is usually a fairly straightforward version of the product. Level or fixed periodic premiums are computed on the assumption that the contract can be retained—assuming premiums are paid—for as long as the insured lives. Premiums are level (higher than actual term costs in early years and lower than the cost of insurance in later years) to make the WL contract affordable for as long as the policy owner wants and is able to pay premiums. Policy cash values (what the policy owner can realize if the policy is surrendered and the insurer is no longer liable for a continuing obligation to keep the coverage in force) are an outgrowth and natural byproduct of the level premium system. WL policies are issued with a table that illustrates the guaranteed fixed cash values the owner of the contract can obtain in any given year, by either borrowing or surrendering the policy.

The defining characteristics of WL are (1) a fixed premium, (2) the guarantees available with respect to both the cash value and the death benefit, and (3) the allocation of assets underlying the contract. The premise of a WL contract is that if the fixed premium is paid for the "whole life" of the insured, the death claim is guaranteed to be paid. For that fixed premium, there will be cash values and death benefits that are guaranteed, assuming that the premium is paid each year for the insured's "whole life" (hence the product's name). However, the *guaranteed* cash values and death benefits are often a good bit lower than the *projected nonguaranteed* values—usually dividends from a mutual company [which include both the guaranteed segment and a nonguaranteed supplement], and it is these latter amounts on which clients are usually most focused.

The dollars that back a WL contract become part of the general account of the insurance carrier, which, under heavy regulation, is typically invested in a portfolio of mid-term bonds, real estate, and mortgage-backed securities. (Depending on the carrier, some relatively small allocations are made to equity investments.) The fixed premium for a whole life contract is calculated by the insurance carrier, so that, if the premium is paid each year (and when enhanced by earnings on those dollars), the guaranteed cash value at some point in the future (often age 100) will equal the guaranteed death benefit. For instance, to pay a $1 million death benefit at age 100, it will be necessary to accumulate that amount by then. It is this relatively conservative, cash-heavy design that sets WL apart from other products and their guarantees. However, WL is most typically presented and/or designed to have a premium paid, on a nonguaranteed basis, for a *finite* number of years (i.e., not each year for the insured's *whole* life). Rather, the premiums are usually designed to be paid only until the accumulation of cash value within the policy, along with future projected dividends, supports the death benefit "forever" on a nonguaranteed basis.

Nevertheless, the best performance of a WL policy can often be achieved when the premium is continued to be paid *beyond* the point where the policies are projected to be self-supporting. In most cases, continuing to pay WL premiums results in accumulations of cash value and death benefit that offer very attractive returns due to the accumulation of dividends, especially given the extremely low likelihood that the cash value would ever decrease. (Cash value in a WL contract would be compromised only in the exceptionally rare event of an insurance company failure.) In short, continuing to pay premiums into a WL contract can offer some of the most attractive after-tax fixed-income returns, given the income tax deferral of the cash value build-up and the tax-free treatment of death benefits currently available.

Although, compared with other forms of CVI, WL is less common today than it once was, especially in the sophisticated estate planning market, it possesses specific advantages that lead to its continued use. It is most generally available from mutual insurance carriers, and is suitable for those seeking the unique insurance attributes of a mutual life insurance company (versus today's more common stockholder-owned structure).

Universal life ("UL") is a "flexible-premium" "current assumption" "adjustable death benefit" type of CVI contract. These contracts are also referred to as flexible premium adjustable life. UL was developed in the late 1970s and early 1980s, as interest rates soared and the change in dividend rates of WL policies significantly lagged behind the interest rates available in the market. In comparing UL policies to WL, the key difference is that UL does not have a fixed premium. Rather, a UL contract is flexible and can generally accept a premium, at any given time, from a very small amount up to the tax limits of the contract. The incredibly flexible premium of a UL policy allowed policyholders more freedom to adapt their future cash flow premium commitments to the dynamically changing interest rate world and their own financial situations and constantly varying needs. Mechanically, as long as there is enough cash inside a UL policy to support that month's charges, the policy will continue to provide full coverage for another month. That said, the actual *recommended* premium for a UL policy is a function of (1) how long the coverage is desired, (2) the number of years the owner wishes to pay premiums, and (3) the assumed rate of interest backing the policy. As these factors change, cash outlay toward premiums can change; further, a policy owner can diverge from a given course at any time. This makes UL a very flexible policy that can be adapted to a client's constantly varying financial cash flow and needs.

When UL was first introduced, it also featured a practical advantage compared to WL in that many of the new UL blocks of business were backed by a portion of a carrier's general account that was, at the time, invested in fixed-income instruments that were newer and, therefore, earning (and returning to those who purchased UL contracts) significantly higher rates of return than WL owners were receiving (because their return was at the time based on assets yielding a much lower average rate of return). As the years have passed, though, the insurer's assets that back UL and the assets backing WL policy series have, essentially, grown together (driven largely by regulation). So both types of policy can be generally thought of as having similar asset characteristics—that of a mid-term fixed-income portfolio. Because of this similarity, UL and WL contracts are commonly lumped together to make up the "traditional" forms of CVI.

UL is indicated in long-term coverage needs where maximum flexibility of premium cash flow is desired, and where the insured's financial needs and cash flow are likely to change. This makes UL suitable in the business, retirement planning, and employee benefits fields to finance salary continuation and nonqualified deferred compensation plans, death benefit only plans, key person coverage, buy-sell agreements, and insurance inside qualified retirement plans.

Variable life insurance ("VL") is essentially a WL policy that allows the policy owner to select among (and typically switch annually or more often between, or rebalance among) a menu of insurer-determined investments similar in many respects to stock, bond, and money market mutual funds. VL provides a guaranteed minimum face amount (death benefit) and a level premium but differs from classic WL in three important ways: First, premiums (after the insurer charges for expenses, sales costs, and mortality costs) are poured into an investment account that is financially separate and legally distinct from the general investment fund of the insurance company. The general account assets are limited by reserving requirements to be invested primarily in bonds and mortgages. For those policyholders who are willing to accept any significant exposure to—and are desirous of—the upside potential of equities, variable life is a good choice. The trade-off is that variable life contracts shift investment risk entirely to policy owners. This means the insurer provides *no* guarantees (or very limited ones) with respect to policy cash values. Instead, investment risk—and potential growth in both cash values and death benefits—are shifted to the policy owner. Cash values in a VL contract are determined as of a given time based on the policy owner's share of the market value of the assets in the separate account. Finally, the death benefit in a VL contract is variable. It may grow or shrink (but not below a stated and guaranteed minimum) according to a formula based on the separate account's investment performance.

The first VL contracts appeared around 1976. The earliest forms of VL were a variation on WL—that is, the premium was fixed, but rather than the assets backing the contract being bound to an insurance carrier's general account, the policy owner now had a choice to allocate some or all of the assets to a separate account, where there is some choice of investment class. The appeal of VL was originally, and still is, driven largely by the ability to access the potential upside of the equity markets. Also, there is a unique appeal to VL in that, in the unlikely event of the insurance carrier's insolvency, the assets allocated to the policy—as part of a separate account—will not be subject to the claims of the insurer's general creditors.

Variable life is indicated where the policy owner (1) is confident he, she, or it can select an account that can significantly exceed the return and growth of the insurer's general account, (2) desires long-term coverage, (3) wants a measure of control over the selection of the underlying investments, and (4) needs increasing life insurance protection. Because policy cash values are not guaranteed and all investment risks (and some death benefit risks) are shifted to the policy owner, VL should be chosen only by those willing to bear these risks in return for the potential upside gains. Some authorities suggest that VL be used primarily as a supplement to a minimum basic level of coverage provided by other types of CVI. (Rybka, "A Case for Variable Life," J. Am. Soc'y of CLU & ChFC (May 1997), and Black and Skipper, *Life Insurance* (13th ed., Prentice-Hall, 1999).)

Variable universal life ("VUL") combines the flexible premium design of UL with VL's ability to choose the asset allocation supporting the contract. Sometimes called flexible-premium variable life or universal life II, VUL is an attempt to capture the best features of UL and VL. VUL policy owners can—within limits—determine the timing and amount of premium payments, eliminate one or more premium payments entirely (assuming cash value is great enough to pay current mortality and expense charges), increase or decrease death benefits (within limits and assuming evidence of insurability with respect to increases), make withdrawals of cash without generating a loan against the policy and without interest charges (assuming there is enough cash value to pay current mortality and expense charges), and select between two death benefit options—one level and the other equal to a level pure insurance amount plus the policy's cash value.

VUL contracts represent a large portion of the insurance sold today. Whether it is because of the many varied types of funds (especially equity-based funds) that are available within the policies, the aspect of the "separate account" resting outside the insurance carrier, the idea of a flexible premium, or some combination of the above, VUL has been a major force in the CVI market for the past decade.

TYPES OF LIFE INSURANCE, *cont'd*

The ability to optimize these features, along with the unique tax attributes of life insurance (tax-free death benefits, tax-free build-up of cash value, ability to reallocate assets without taxation, and, uniquely, the ability to withdraw after-tax basis and access gain without current taxation), can create a powerful financial instrument that is particularly appealing to high-income, high-net-worth individuals and businesses.

VUL is particularly indicated for estate planning and business insurance needs where the potential increase in cash values and death benefits resulting from the successful exposure to underlying assets invested in the equity markets is deemed attractive or necessary. If a policy owner believes that the portfolio he or she can assemble (from the available choices) underlying the policy will significantly outperform the assets of the (tightly regulated) insurance company's general account, VUL can make good sense.

Further, VUL offers the best protection of a policy's cash value from future adverse changes at an insurance carrier, or indeed from carrier failure, thanks to the fact that the assets are held in a separate account from the carrier. (Many practitioners speculate that, based on past experience, some carriers may not return to policyholders enough of the "upside" of their general account performance in other types of CVI policies, due to future changes at carriers, carrier consolidations/mergers, etc. The separate account feature of VUL insulates these contracts from some of these concerns. Even with VUL, however, the nonguaranteed insurance charges within a policy will still be subject to future carrier performance.)

VUL contracts are appropriate for key person coverage, Section 162 (executive bonus) arrangements, financing of salary continuation and nonqualified deferred compensation plans, death benefit only (survivors' income benefit) plans, key person coverage, buy-sell agreements, and insurance inside qualified retirement plans.

(Continued from page 15)
owned life insurance, the existence of a sizeable lifetime cash value is, at best, of secondary importance to trust beneficiaries, given that any such cash is likely to have been tied up in the trust anyway.

On the other hand, the lack (or non-existence) of cash value within an NLGUL contract creates a "last stop on the train" phenomenon—that is, the policy owner's options to perhaps make a change in the future will be very much limited, if not precluded. The policy owner needs to be *permanently* comfortable with those death benefit returns of the NLGUL policy because once the policy owner gets on this train, the reality is that it is quite difficult or expensive (economically) to get off.

NLGUL also bears the solvency risk of the carrier issuing it, especially because the low cash value and attractive guarantee of the death benefit create a situation where the policy's risk is less likely to be transferred elsewhere in the future. Those advisors who are comfortable with this point out that this risk does, to at least some degree, exist with *any* insurance, and there are some protection mechanisms to mitigate the risk. Some authorities,[5] however, argued that these policies increased the solvency risk of carriers that issue them, particularly those insurers that may have underpriced their NLGUL products. The greatest risk to policyholders is the possibility that, in an insolvency, the rehabilitator would "reform the contract." Most state guarantee funds provide only that limited death benefits and cash value will be paid. This risk is more than theoretical; contracts have, in fact, been reformed in the several large insurance company failures.[6]

Finally, the last potential disadvantage of NLGUL is that, while the death benefit is likely to have relatively little downside, NLGUL is also less likely than alternative contracts to have a notable performance *upside* in the event of rising interest rates, or bull equity markets (which could positively drive the WL/UL and VUL markets, respectively).

Those who favor NLGUL would counter that the lack of upside is a fair trade-off for the very attractive "locked-in" IRR at death. Obviously, an NLGUL contract is most appealing and appropriate for high-net-worth clients seeking to assure the financial security of future generations through the most cost- and tax-effective and economically certain wealth transfer mechanism possible, the ILIT.

Rise in popularity of NLGUL

NLGULs became more and more price competitive as the cost of a guaranteed death benefit, backed by the strength of the insurer, had to compete with other similar products in the marketplace. As mentioned above, this became the product of choice for many advisors over the last eight to ten years for estate planning—ILIT-owned, low-cash-

5 See Rybka and Jones, "Guesses, Projections, Promises & Guarantees," 59 J. Soc'y Financial Service Professionals No. 4 (July 2005). Rybka and Jones note, "While secondary guarantees constitute an unequaled marketing success, they have triggered growing concerns among the industry's leading pricing actuaries and rating agencies. Some companies having large blocks of secondary guarantee products may, in some circumstances, cause long-term financial impairment to their reserves and create risk for those very policyholders who were seeking the safety of guarantees."

6 The secondary guarantees in some existing products assume an interest rate earned by the insurer of as much as 5% for the *lifetime* of the product! This point and the carrier's obligation to guarantee that high a rate for that long a period go to the heart of the underpricing (over promising) concerns of the authors (and of several major carriers).

value, guaranteed death benefit, low-premium coverage. Death benefit performance risk is shifted to the insurer—with the caveat that *the owner must pay the premium when due—on time*. (*Beware:* If the premium is *not* paid on time, the guarantees can be compromised or even entirely lost!) So the major trade-off for low-cost guarantees is a loss of premium-paying flexibility.[7]

If "primary guarantees" within current assumption universal life policies refer to maximum "expense" and maximum "cost of insurance" ("COI") (mortality) charges and minimum interest crediting rates, then "secondary guarantees" refer to death benefit and premium requirements. One insurance authority[8] put it this way:

> In general, the secondary guarantee feature of the UL policy provides that for specified premiums, paid at specified times, the death benefit will stay in force for a stated period of time. The death benefit will stay in force even if the underlying policy *would* have lapsed in the absence of the secondary guarantee. In other words, even if there is a dramatic drop in the crediting rate or significant increases in the COI charges, the secondary guarantee keeps the policy in force.
>
> However, for the secondary guarantee to provide this level of protection, it has to be active. And that requires strict adherence to the provisions of the policy and an understanding of how certain actions can inactivate or even terminate the secondary feature.

Problems begin

Of course, when life insurance products can be reduced to their most basic elements, they are soon commoditized. Price becomes the major, if not sole, issue some people focus on. So companies and insurance agents had to find other ways to distinguish themselves and their products in the marketplace.

Underwriting was and continues to be a differentiator. Which companies will issue policies at the best ratings? Premium-paying patterns and length of guarantees became differentiators. For example, perhaps a client would like to obtain a guarantee of coverage until age 90, rather than pay the additional premium for a lifetime guarantee. From the perspective of gifting and internal rates of return on death benefits, perhaps "step premiums" are appropriate—e.g., paying an increasing annual premium in three-, five-, and nine-year tranches. (These "catch-up" increases can be significant.) Consequently, each of these scenarios had the potential of reducing profits for the insurance industry.

Where to from here?

We experienced an earthshaking change in the early 1980s from whole life to universal life with its consequent shift of risk to the policy owner. In the 1990s, there was a further move to equity-based variable universal life. Post-2000 saw no-lapse, guarantee products take center stage.

Now the question is, "What life insurance products remain appropriate for estate planning situations?"

2009 has been a year of important product changes in the life insurance industry. Increased economic pressures have forced insurers of all sizes and shapes to recon-

[7] Some companies offer flexibility here by allowing a "grace period" to pay the NLG premium.

[8] Hanna, "Understanding Secondary Guarantees: The Finer Points You Must Know," Broker World, p. 34 (Oct. 2006).

Practice Notes

It is likely that even more companies will curtail or totally eliminate sales of no-lapse guarantee products and still others will cut back on their guarantees.

sider their product offerings. Companies are withdrawing, compromising, and/or re-pricing (i.e., increasing premium) their no-lapse, guarantee (as well as their long-term (i.e., 20- and 30-year), level premium term insurance) products.

Consider the following changes in products just since January 2009:

- At least six carriers (including American General, Axa, Genworth, ING, NY Life, and Pacific Life) have discontinued or significantly modified all or some of their no-lapse guarantee products. The carriers modifying their product have limited the duration of death benefit guarantees.
- At least eight carriers (including Axa, Genworth, ING, John Hancock, Lincoln Financial, Protective/West Coast Life, Prudential, and Sun Life) have increased rates on some or all of their no-lapse guarantee products and/or riders.
- At least ten carriers (including American General, Aviva, Axa, Genworth, ING, John Hancock, Lincoln Benefit Life, Protective/West Coast Life, Prudential, and Transamerica) increased rates on term coverage and/or discontinued their 30-year term products or return of premium features.

Profitability is being affected by investment losses (realized and anticipated), capital and reserving requirements, and the cost and availability of credit. All these issues are driving product changes.

Insurers have not felt the full impact of investment losses yet, but they know there are more on the way. Insurance carriers hold a huge amount of bonds in their portfolios. They are also affected by the debacle in the mortgage market. As bonds are downgraded and considered more risky, there is a direct impact on an insurer's risk-based capital. The spread between minimum interest crediting rate guarantees and fewer investment alternatives to exceed those rates in the marketplace is the source of enormous strain for life insurance companies. Basically, some insurers are guaranteeing higher rates than they can currently obtain in the marketplace. This inevitably will affect their profitability—substantially.

Redundant reserving requirements and the cost of meeting those requirements are the most important drivers going forward. For example, a company might have to ultimately reserve \$7-\$8 for every \$1 of premium for a 30-year term insurance product. It might have to reserve \$10-\$12 for every \$1 of premium for a survivorship (second-to-die) policy. Actuaries have been working diligently on reserving methodologies[9] to avoid redundancies, reduce costs, and still preserve the integrity of the guarantees.

What's all this have to do with NLGULs and why should estate planners care?

The bottom line is that long-term guarantee products require the most reserves and exert the most pressure on an insurer's capital. Thus, the products that we use most often in estate planning are precisely the products garnering the most scrutiny by insurance companies and in the coming months and years are likely to experience the most change.

Making predictions—especially those about the future—is always risky. But as we noted above, insurers already have begun to discontinue and withdraw products that are causing them the most problems—i.e., strain on capital. It is likely that even more companies will curtail or totally eliminate sales of no-lapse guarantee products and still others will cut back on their guarantees. Perhaps new contracts they issue will not provide *lifetime* guarantees, but will go out to only age 85 or age 90 or will offer the lifetime guarantee only at significantly higher rates.

Planners can expect a continuing-to-change landscape. The questions are: "Is the direction outlined above short-term or long-term?" "How do professionals navigate these waters on behalf of their clients?" "Is it in a client's interest to secure coverage *before* these likely changes occur?" "How long will the window of opportunity be open until these rate increases or reductions in assurances take place?"

A guess—and it is only a guess—is that we will see many more significant product changes and price increases and less favorable contractual terms over the next 24 months. That *may* be followed by some easing if credit markets continue to open up and if the actuaries and regulators can come to agreement on appropriate reserving requirements. These are the really big issues.

Additionally, no-lapse guarantees could become *de rigueur* once again as carriers experience higher interest rates and become more comfortable with their reserves.

9 There have been two main sources of funds for reserving that have been available to insurers in past years—reinsurance arrangements and letters of credit. But recently, reinsurers have backed away and the cost of letters of credit has increased significantly. Capital remains scarce and expensive, and these costs will be reflected in the future pricing of insurance products.

In the meantime, however, there will be new products coming to market. What will they look like—more expensive no-lapse guarantees, without no-lapse guarantees, or with compromised no-lapse guarantees? There will be indexed universal life, variable universal life, current assumption universal life, etc. What should estate planners recommend going forward?

Conclusions

Although no-lapse guarantee life insurance policies, both individual and survivorship (second-to-die), will be offered by fewer companies at slightly higher cost, they will be offered by those life insurance companies that want to continue being prominent in the high-net-worth marketplace. The choice for our clients will be between guaranteed no-lapse coverage with a guaranteed premium and a guaranteed death benefit at slightly higher cost than it was previously versus a current assumption product illustrated at guaranteed minimum interest crediting rates and current costs of mortality and expenses at the same cost, but with potentially greater cash values.

Many high-net-worth clients place relatively little importance on the amount of cash value in an ILIT. They have grown weary of underperforming life insurance products, broken promises, and serial Section 1035 exchanges. Clients are tired of hearing about projections and assumptions in illustrations.

Two key questions typically in their minds are:

- "What is the lowest guaranteed premium necessary to provide a specified guaranteed death benefit for as long as I live?"
- "What will it cost to have life insurance in-force at my death *whenever* that may occur?"

They want to know that, if they pay the premium on time, the beneficiary will receive the promised death benefit. Then, they can decide *if* and how *much* they want.

If our clients end up paying a little more for no-lapse guarantees, for peace of mind, that is potentially a small mistake. If our clients bet on paying a little less for a nonguaranteed product and have to *hope* for performance, that could be a *big* mistake. So, in spite of all the noise that will be heard, it will be business as usual. It is likely that no-lapse guarantee products will continue to play a large part, if not dominate, the trust-owned, estate planning marketplace.

At no time in recent years have practitioners had as many cost-efficient options to (1) help clients "match the product to the problem," (2) better address clients' changing needs and premium paying circumstances, and (3) accomplish overall tax and estate planning objectives. This unprecedented opportunity is accompanied by a responsibility and professional obligation to work with competent insurance specialists to learn more about the pros and cons of currently available and emerging life insurance products and how they can be used to meet clients' needs and goals. It will be incumbent on all financial services professionals to keep informed about life insurance product changes in a fast and ever-changing marketplace. ■