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It's the Hottest Thing in Life Insurance. Are Buyers Aware of the Risks?

Regulators worry insurers are underplaying the dangers of a product tied to the performance of the U.S. stock market

By Leslie Scism
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Sales of a life-insurance policy tied to the longest bull market in U.S. history are soaring. Regulators worry that buyers are unprepared for a crash.

Indexed universal life is one of the insurance industry's hottest products. It accounted for a quarter of all individual life sales as measured by premium for the first nine months of 2019, according to research firm Limra, up from 20% in 2014. Before the decadelong stock market boom, these policies were just 4% of sales in 2008.

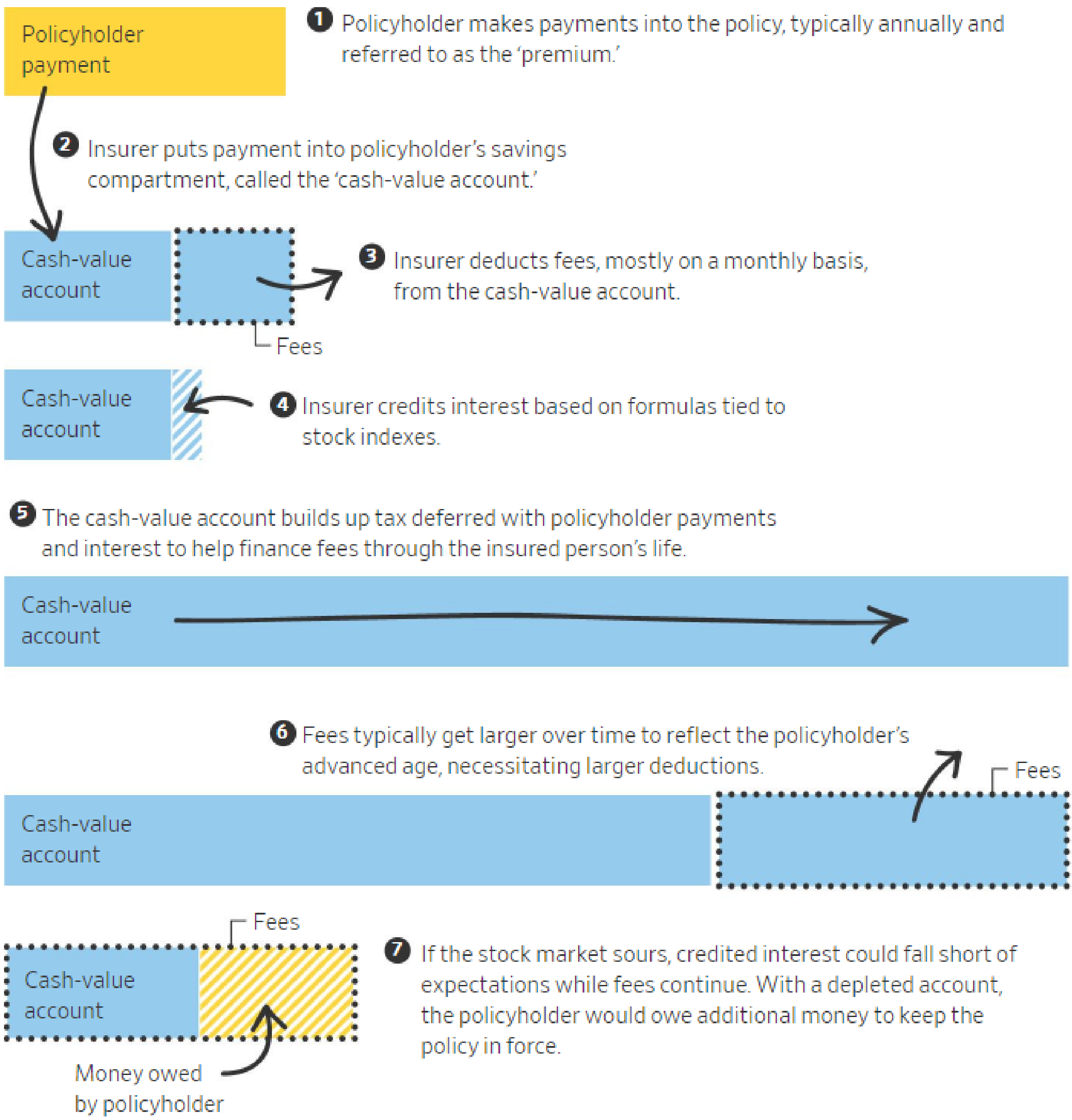
The product's appeal is that it promises annual interest based on formulas tied to stock indexes like the S&P 500 as well as protection against losses. Some policies offer newer features known as "multipliers" that promise even higher annual interest, for higher prices. Costs vary across companies' product lineups and industrywide.

For now the policies are benefiting from a historic stock-market run. The danger: If the market goes down or flattens, all some buyers may be left with is an unaffordable insurance bill.

Know What You're Getting

Indexed universal life is a type of 'permanent' insurance, designed to be in force until death. It includes both a death benefit and a savings account that earns interest to help pay future policy costs.

The basics and some pitfalls



Note: Values shown aren't to scale; fees and payments vary widely industry-wide
Source: staff reports

An indexed universal-life policy is "often postured as an investment vehicle where you can't lose," said Bill Boersma, a life-insurance consultant in Grand Rapids, Mich., who charges fees to review insurance policies often at the behest of family attorneys. "Unfortunately that's not true." He said the potential problem isn't front and center right now because the policies "have largely been in force only during a historic bull market."

Regulators are taking notice. A standards-setting organization for state insurance departments aims to have new rules in place by midyear to rein in overly rosy pitches tied to the new features. The planned new regulation will restrict insurers from showing better illustrated results for products with the features than those without.

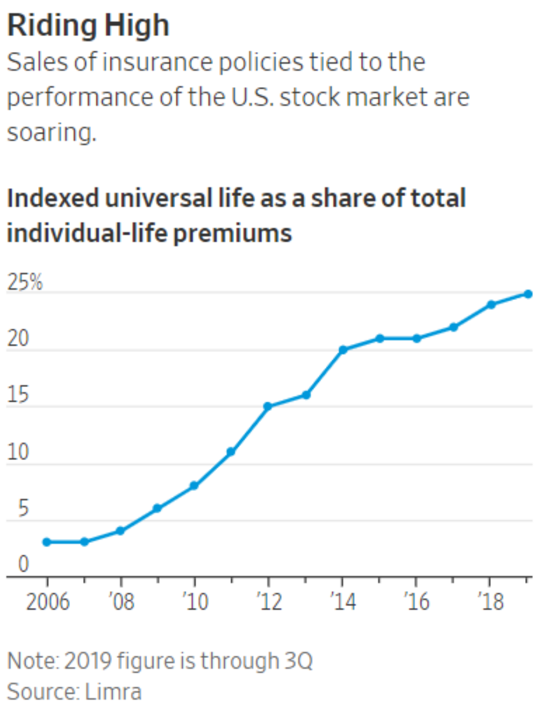
Some aspects that can work against the policyholder may have gotten short shrift in sales pitches, according to some regulators, industry executives, financial advisers and consumer advocates.

One concern is that existing consumer materials "can lead to unrealistic expectations," said Fred Andersen, an actuary with the Minnesota Department of Insurance who is a leader in the effort at the National Association of Insurance Commissioners.

Paul Graham, chief actuary with trade group American Council of Life Insurers, said the industry supports development of materials and disclosures that help consumers "make the right decisions," though "we do have different views amongst our companies as to how to best accomplish that on rather complex IUL products."

This isn't the first time regulators have looked to tighten rules for these hot-selling policies. In 2015 the National Association of Insurance Commissioners limited the annual interest rate that can be used in a projection of how the policy will perform over time. Policies tied to the change of the S&P 500 index are currently limited to an "illustrated rate" that averages 5.92% under a formula adopted by the organization, according to market research firm Wink Inc. in Des Moines, Iowa.

The 5.92% is lower than the 11.23% annualized compounded gain of the S&P 500 index excluding dividends since the end of 2009 through Dec. 31, and just under the 6.26%-a-year increase since 1926, according to S&P Dow Jones Indices.



Some regulators and advisers fear indexed universal life will offer a repeat of what many consumers experienced with a policy known as basic universal life. Those policies were a sensation in the 1980s when U.S. interest rates were in double digits.

But rates fell to historic lows over time. Interest accumulation slowed and expense deductions over time depleted many policyholders' savings buildup.

Some customers now in their 70s, 80s and 90s are paying thousands of dollars a year to keep just modest policies in force, when they thought the policies would be self-sustaining, while others have canceled their coverage.

Demand for indexed universal life surged in recent years as low interest rates made more conventional bond-based policies a tougher sell. A run-up in the stock market following the 2008 financial crisis provided another incentive.

The policies offer a type of "permanent life" insurance, meaning it can be in place until death. That is in contrast to "term life," a death benefit paid if the insured person dies within, say, 20 years. Permanent life includes a savings compartment so money can build up to offset some of the annual costs over time.

In short, the buyer of an indexed policy pays “premiums,” typically annually, into a “cash-value account,” and the insurer deducts for various costs, usually monthly. if the premium exceeds costs, the extra amount stays in the account earning tax-deferred interest. The tax deferral makes the policies attractive to some people who need insurance and have maxed out tax-advantaged retirement-savings plans like 401(k)s.

In crediting interest, some insurers use a “participation rate,” under which they pay a designated portion of the index’s gain. For S&P 500-linked policies, participation rates range from 34% to 100% of the gain for each 12-month period from the point of sale, according to Wink. (Say, if the index grows 10%, the insurer pays 3.4% to 10% interest.)

Other insurers specify a maximum interest rate, and 10.77% is the current average, according to Wink.

Another wrinkle: Insurers generally retain the contractual right to change these percentages, subject to regulator-approved limits. They also typically can raise the cost of the death benefit, per contractual provisions.

“We joke that it takes an actuary, an attorney and sometimes an engineer to understand the calculations,” said Billie Resnick, co-author of an American Bar Association book on life insurance and an independent adviser in Naples, Fla., to affluent families.

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