8 Precautions When Using Indexed Universal Life to Save for Retirement

A few facts that advisors-- and their clients -- should keep in mind before committing their hard-earned dollars to this retirement savings strategy.

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The first **index universal life** product was brought to market a mere nine years ago, yet sales for this product line have grown substantially each year. In fact, last year's sales of index universal life exceeded $550 million of annualized premium.

A key reason that index universal life has become so popular is that a large number of agents and marketing organizations are promoting it as an excellent product in which to save money now to produce a steady cash flow later in retirement. Last month, we examined eight advantages of using index universal life to save for retirement. This month, in the interest of full disclosure, we will examine eight **precautions** when using index universal life to save for retirement.

These are not necessarily reasons against using **index universal life to save for retirement**. They are merely facts that buyers should keep in mind and seriously consider before committing their hard-earned dollars to this retirement savings strategy.

1. Buying index universal life is a long-term commitment.

1. It's not uncommon for the cash value of an index universal life product to be well below the premiums paid for a number of years after issue, nor is it unusual for an index universal life product to have surrender charges that last 10 years, 15 years or longer. As a result, one should not buy index universal life with the idea of moving the money later when another type of savings or investment vehicle appears more attractive. Index universal life is not well-suited to someone with a frequent trader mentality.

2. The requirement to pay mortality charges.

1. For a client who intends to buy index universal life purely to save for retirement, there is no escaping the fact that it is life insurance; thus the client must have mortality charges deducted from the contract value. These charges naturally offset some of the benefits of the interest crediting on the contract, reducing the net return that ultimately stays in the contract value. Particularly if the client is older, uses tobacco, or is in questionable health at the time the contract is purchased, the mortality charges can be quite substantial.

3. The ability of the carrier to change mortality charges.

1. In most index universal life contracts, the mortality charges against the contract's value increase over time as the insured client ages. While carriers illustrate this in any proposals that the agent provides to the client, clients need to keep in mind that carriers reserve the right to increase mortality charges beyond the increases already shown in the illustration.

4. Possible bond-like returns over time.

1. Index universal life provides for an index-linked interest credit at the end of each crediting period with the guarantee that the interest credit can never be negative. This is a very attractive feature. But remember that carriers invest the vast majority of their index universal life premiums in bonds. This means that clients can expect, over a long period of time, for the average return on their index universal life product to be in the same range as bond returns. To clients who strongly believe that stock returns will soundly beat bond returns over time, this is a disadvantage of index universal life.

5. The ability of the carrier to change some element of the interest crediting formula.

1. In most index universal life contracts, the carrier provides an interest crediting formula that has a cap, participation, or spread rate that the carrier can change from time to time. The carrier does this simply because it is unaffordable for the carrier to provide a strong long-term guarantee on the index-related interest crediting formula. For the client, this means that a formula that is attractive for the first interest crediting period can be changed by the carrier to be unattractive in later interest crediting periods.

6. Illustrations are unreliable.

1. Index universal life is often sold as a retirement savings vehicle through the use of an illustration that shows premiums for a period of years, followed by a series of contract

loans over the retirement period. It is not unusual for such illustrations to show values 20 years, 40 years or even more years in the future. Keep in mind, however, that the underlying index return may differ greatly from the assumptions used in creating the illustration. Plus, as we already mentioned, the carrier has the ability to change the mortality charges and certain elements of the interest crediting formula over time. All of these items conspire to render long-term illustrations unreliable.

7. Management changes at the carrier can result in bad treatment.

1. Because the carrier has the ability to change the mortality charges and certain elements of the interest crediting formula over time, the performance of the contract is heavily dependent upon how fairly company management sets these elements throughout time. There is always the possibility that future management at the company could choose to maximize its profits at the expense of its existing customers. Thus, it makes sense to buy from a carrier that has a well-established, customer-friendly brand name whose reputation it needs to protect.

8. Contract lapse can create a tax disaster.

1. Ideally, using index universal life to save for retirement means this for the client: paying a premium for a limited period of time, then receiving tax-free contract loans over time that greatly exceed the premiums paid, and ultimately having the accumulated contract loan paid off at death by a tax-free death benefit. This can all work beautifully, unless the accumulated loans cause the contract to lapse. If that occurs, the contract holder is taxed on the sum of the cash taken out of the contract less the premiums that were originally paid. The tax due can be a substantial lump sum, and usually the contract holder has already used up the cash that the contract generated. Some carriers provide coverage provisions to prevent this from happening, but some leave the responsibility to monitor this up to the client.

Does this make index universal life a terrible place to save money for retirement? Absolutely not. In fact, index universal life can be a very attractive place to save money for retirement. Last month, we examined the eight advantages of using index universal life to save for retirement, and they are quite compelling.

However, a truly informed customer should enter an index universal life contract with full knowledge of these eight cautionary items. For the reasons stated above, it makes sense to diversify across a variety of retirement savings strategies, and not to rely upon index universal life as your sole retirement strategy.