Steve Leimberg's Financial Products Planning Email Newsletter - Archive Message #30

Date: 08-Jul-22
From: Steve Leimberg's Financial Products Planning Newsletter
Subject: Bill Boersma: Risk Profiles of Life Insurance – Don't Take Conventional Wisdom at Face Value

"While many professionals and policy owners have a vague realization that the life insurance industry has evolved over the years, the extent to which it has often isn't fully appreciated. There still exist different universes of life insurance products, but their boundaries are fuzzier and often overlap. As a result, the traditional understanding of the risk profiles of various products, whole life relative to universal life, general account products relative to securities-based products, isn't as crisp as it once was. It's important that those who advise, as well as consumers, have a more thorough grasp of the various iterations of modern life insurance products."

Bill Boersma provides members with timely commentary that examines life insurance risk profiles.

Bill Boersma[i] is the founder and principal of **OC Consulting Group**, a nationally operating, fee-based life insurance consulting practice. He has spent his entire career specializing in life insurance and predominantly works with wealthy business owners and professionals. Bill is generally introduced by attorneys, CPAs, family offices, trust officers, non-profit leaders and financial planning professionals. From second opinions to in-depth analysis, acquisition to divestiture support, engagements for litigation and expert witness work, tax analysis, life settlements, policy valuations or anything conceivably associated with life insurance, somewhere in the country an advisor is introducing Bill to bring value to their clients. Bill has written for, been featured in or quoted by numerous financial, legal and accounting periodicals and websites. He regularly speaks for estate planning councils, legal, accounting and trust management conferences and financial and insurance associations, as well as for individual companies and practices.

Here is his commentary:

EXECUTIVE SUMMARY:
While many professionals and policy owners have a vague realization that the life insurance industry has evolved over the years, the extent to which it has often isn't fully appreciated. There still exist different universes of life insurance products, but their boundaries are fuzzier and often overlap. As a result, the traditional understanding of the risk profiles of various products, whole life relative to universal life, general account products relative to securities-based products, isn't as crisp as it once was. It's important that those who advise, as well as consumers, have a more thorough grasp of the various iterations of modern life insurance products.

COMMENT:

Sometimes life insurance is segregated by risk profile. We all know that traditional whole life is the most conservative, right? And variable universal life is the riskiest, duh. But is it this cut and dry?

Let's first define the major universes of life insurance. On one hand we can differentiate between term and permanent insurance. Within the permanent insurance world, we basically have whole life (WL) and universal life. Universal life is broken down into traditional, current assumption UL (UL), guaranteed UL (GUL), and indexed UL (IUL). Variable life is a securities-based product and it can be built on either a whole life or a universal life (VUL) chassis. Private placement insurance is another version of VUL. Got it?

A Little History

Years ago, there was only whole life and term. It wasn't until the very end of the seventies that universal life was introduced as a result of the skyrocketing interest rates. It was a "new money" product as opposed to a "portfolio rate" product like whole life. I feel it's safe to say that whole life was more conservative and had more guarantees than universal life in the beginning, but it didn't stay that way. About 20 years after UL came on the scene, GUL showed up. Whether some like GUL or not, GUL is a guaranteed product. If you pay your premiums per the contract, you get your death benefit, guaranteed. Isn't this fundamentally the same promise as with whole life? Clearly there are significant differences and I'm not saying WL and GUL are basically the same, or even similar; not even close.
A strange thing happened, though. Over time, WL gained the ability to be less guaranteed. In order to compete with high interest assumption UL, some WL producers started layering term insurance into the contracts to reduce the premium. The caused the UL vs. WL conversation to become somewhat muddied. Though this is blasphemous to some ears, there were many UL policies going out the door with more guarantees than WL. Regardless of how a tortured explanation could attempt to refute this, when a whole life policy is issued with term insurance blended in or on a non-guaranteed short pay basis, it is in no way as guaranteed as a GUL policy. Also, GUL doesn't project greatly growing, and largely non-guaranteed, cash values and death benefits.

Don't Take Anything For Granted

Go back to the opening paragraph, knowing what we just covered, we can't take anything for granted. What we can know is that the title of a product isn't as important as the nature of it. How is it built? What are the assumptions? Is it funded properly? Is a 99%/1% whole life policy (a real thing) really whole life? Technically yes, but really, no. Wearing Italian driving gloves while driving a Chevy doesn't make it a Ferrari.

How does traditional UL, IUL and VUL compare? Sometimes UL is referenced as a fixed rate, general account product while VUL is referenced as a securities-based product, with IUL pegged as a hybrid of the two. In reality, IUL is a general account product, the same as UL, but with a twist. What it is not, is a securities-based product, to the surprise, and chagrin, of many.

But UL has to be more conservative than VUL, clearly… right? You probably know where this is going. It's not that clear. Again, what something is called is not as important as what something is. I've seen many UL policies built on a razor's edge and VUL policies built rock solid. I've written entire articles on how a good looking UL policy can crash and burn if its crediting is reduced modestly from projections (sometimes literally a couple of basis points) or it doesn't earn its return in the right sequence.

On the other hand, I can build a VUL policy that ends up earning hundreds of basis point less than projected and still pay a death benefit. How? Why? Think about this; what's more likely to get you to your vacation home? A new Mercedes with a gallon of gas or a well serviced 2009 minivan with a full tank? What investment will get you to retirement faster? A 10% return with a 4% expense or an 8% return with a 1% expense? What house do you want to be in when the big, bad wolf comes blowing?

Build It Right and It Will Last

You can build a VUL contract to grow like a bad weed in good times and be healthy enough to weather the inevitable storms. You can build a UL contract that looks golden on paper but wilts as soon as it's mildly stressed. The main problem I see is that too many contracts are built to look good on paper but have no ability to handle fluctuations or downturns. How many people are really surprised when there are downturns? They've always happened and they always will. Why not be ready for them? Many life insurance policies are sold on projections that assume everything forever stays exactly like it is right now, with not a fraction of a crediting point difference or an expense that changes in the slightest. We're know that's factually impossible but the contracts go out the door like that anyway.

I'm working on an IUL case now that was put in force in 2015. The client understood it to be fairly conservative and that it would last indefinitely. It has actually had a crediting rate, inception to date, that exceeds the original projections, yet it's behind the ball and won't last nearly as long as expected. How it that possible when the stock market was on fire most of that time. First of all, the cash value of an indexed product isn't actually in the market (gasp!) and the cap rate went from 14% to 7% so all those great "returns" (driven by the underlying options) are off the table. The client was incensed to hear this. He had no idea. But he wasn't as incensed as when I told him the guaranteed minimum cap rate was 3%.

We're pulling out every trick to get this policy to survive and keep the client from losing all the money he's put into it. But it didn't have to be that way. First, he should have been educated on how this kind of policy actually worked. Next, if he understood, he could have challenged the agent regarding appropriate funding. If the policy was funded right it could've weather the head winds of the financial markets, general account returns, options pricing, home office decisions and lack of advisor management.

Risk & Reward

Here's the irony. We know all about risk and reward, it's a facet of life, from investments to asking the pretty girl in home room out to a movie. In general, just like bonds don't have the risk of stocks and knitting doesn't have the risk of motocross racing, WL doesn't have the risk of VUL. But it could. It all depends. I can build a VUL today as hollow as a spreadsheeted, minimum funded VUL at 12% in 1999, or solid enough to last indefinitely, even if it was unlucky enough to start out with 10 years of negative 10% annual returns. That's about the same as comparing a 99% term blended UL to a 100% all base guaranteed 10 pay whole life.

Most policy owners don't know there is term insurance in their whole life life when I inform them. Most people don't know that $10 million of death benefit could have a premium of $50,000 or $250,000, maybe in the same product with the same carrier. My most uneducated client knows that can't be apples to apples, but my most brilliant client can't tell me why.

Don't assume anything. I'd rather have some VUL policies rather than some WL policies and I'd rather have some WL policies than some VUL policies. As tough as it might be to internalize this conceptually, turning that knowledge into something you can do something with to help your clients is a whole other ballgame.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Bill Boersma

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