

# Steve Leimberg's Financial Products Planning Email Newsletter - Archive Message #25

**Date:** 07-Oct-21  
**From:** Steve Leimberg's Financial Products Planning Newsletter  
**Subject:** William Boersma: What's Happening in the Premium Financed IUL Market

*"In what many advisors are describing as a watershed development, four major life carriers recently restricted or suspended premium financed IUL sales. At first glance, premium financed IUL can appear to have a compelling narrative. You're rich and sophisticated, so naturally you want to do what other rich and sophisticated people do. Why use your own money to pay for insurance when you can use other peoples money at historically low interest rates to buy a policy that has upside market opportunity without the downside risk?"*

*How would this be possible? A primary marketing hook of IUL contracts is the fact that they have a floor, such as 0%, so the cash value crediting cannot experience a negative return. However, not realizing a negative return is not equivalent to not losing money. These IUL contracts also have a capped limit to the upside potential, let's say 10%, regardless of the S&P 500 Index return for the period. This is, in effect, a collared return.*

*Why not forfeit some upside in the good years to avoid experiencing loss in the bad ones? The opportunity to realize 10% while facing no negative return risk can be quite attractive. When the S&P 500 projects to grow your cash value handsomely over time, you can withdraw or borrow some of that cash value, tax free, to pay back the loan. Your life insurance rides the remaining cash value for the rest of your life and you have beaten the market. Based on my experience, this is the often pitch used to market financed IUL policies."*

**Bill Boersma** provides members with important and timely commentary the examines the state of the market regarding financed IUL policies.

**Bill Boersma** 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:**

In what many advisors are describing as a watershed development, four major life carriers recently restricted or suspended premium financed IUL sales. It may seem like critics are beating up on indexed universal life (IUL) lately. However, the issue is not whether we are for or against it. Rather, the goal is to share the critical importance of understanding what an IUL policy is and what it is not. To highlight that importance, we point to real-life stories about blindsided policy owners who may never have fully understood how the indexed universal policies they purchased operate or how they mesh with external bank financing.

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## **COMMENT:**

### **What Clients Don't Understand**

Premium financed IUL life insurance contracts are frequently so complicated that it's difficult to know where to begin, and prospective policy owners do not have an appreciation for the level of complexity that's involved. In fact, many believe these programs are rather simple and straightforward. Most of this confusion centers on the IUL product itself.

First, most clients never realize that their premium dollars are not going into the S&P 500, or into any equities for that matter. IUL contracts are not securities, and the contract's cash value is part of the general account of the insurance company that is largely required to invest in high quality bonds. This is often where expectations and reality start to diverge because clients expect equity returns even though their premiums were not invested in equities to begin with.

Where do the projected returns come from? The carrier uses a small bit of the premium and income from their bond portfolio to purchase derivatives to credit the upside gains to cash values. The carrier does not need to limit the downside losses because their client's money is never in the market, so there cannot be a loss from an investment perspective, which is very different from experiencing a loss in cash value.

If a carrier is earning 4% in their general account and can illustrate a 6% crediting rate in their IUL contract, they are assuming a 50% gain or profit, and that is basically what is assumed under the complicated rules behind this product known as actuarial guideline 49 or AG-49 / AG-49A. That is a significant assumption to make year in and year out for the indefinite future.

## A Case Study

Let's look at some real-life numbers for a case we are reviewing for a client who borrowed significantly from a bank to buy into one of these contracts:

- This client purchased a \$5,000,000 IUL policy in 2015 and the policy's premiums were \$517,000 per year for seven years, with the final payment due in a few months. The money was all borrowed from a bank with the policy and other assets pledged as collateral for the loan.
- In this case, the premium financed IUL was built particularly "skinny", meaning there was no room for error. Unfortunately, the real world never works like the sterile, unrealistic insurance proposal. The original illustration did not account for significantly reduced caps rates, and subsequently, reduced crediting and realized rates. Something has to give. There will either need to be more premium needed, more interest paid, a reduced death benefit expected, more collateral assigned, less supplemental income expected or a combination of some or all of the above. Two plus two can't equal four when one of the twos is actually a one.
- New ledgers from the insurance company show this policy, which was originally designed to make it to age 100 with a \$5,000,000 death benefit after paying off over \$3,600,000 in loans, is now projected to collapse after the loan is paid back and no death benefit will be paid. Additionally, roughly \$2 million of interest will have been paid along the way. The illustration assumed an unsustainably low loan interest rate continuing indefinitely, and the highest regulatory allowable policy crediting rate built on unrealistic assumptions. It will all, more likely than not, be worse.
- In any situation a policy owner needs to identify and quantify bail out options; if the deal won't work, what does it cost to get out of it? Also, what would it take to get things back on track given lower policy crediting and/or higher loan rates moving forward?
- For this situation we are first identifying how much additional premium the policy requires to have a reasonable chance of persisting. Moving forward from today with no additional loans, it will take over a million dollars of additional premium to hit the original target at today's maximum crediting rate and twice that to fund the policy more responsibly that will allow it to absorb the world's inevitable variables. Even then, the policy needs to be managed closely to make sure it's on track. This is in addition to seven figures of additional interest to be paid out of pocket.
- In a best-case scenario, assuming great crediting and minimal loan interest, the client is looking at a cash flow in the neighborhood of what a contractually guaranteed premium and death benefit policy would have cost him in 2015, paying all premiums out of pocket with none of the risk he assumed with his current IUL policy. In a more realistic case, he's looking at laying out more cash value than the death benefit he would have had with a guaranteed contract.

## Projection Vs. Reality

The circumstances of this case are ideal for illustrating how the original projections of a premium financed IUL product compare with the policy's current reality.

Equity markets have run hot and borrowing rates have remained very low on the loan since the policy was purchased. The S&P 500 annualized return during the period this policy has been in force is 14.53%. Without dividends (that aren't included in the S&P 500 Index products in question, to many people's surprise) the return is 12.47%.

It seems that of all periods, this case is a model for an indexed policy with five out of six years being up and hitting caps. In fact, when we look at the current, inforce ledger from the insurance carrier, it states a 7.57% average index crediting rate since the policy's inception. This makes it even more curious that the actual cash surrender value of the policy today is less than it was projected to be when the policy was issued, and the projected crediting rate was only 6.25%.

When a stock market that has been on fire for years cannot drive an IUL policy to outperform projections at a meaningfully lower rate, clients can be put in a difficult position. If a policy cannot succeed under one of the most successful stock market run ups in history while using a premier carrier, while loan rates have stayed unexpectedly low, then how can it ever be expected to succeed?

## How IUL Crediting Rates Work

With an IUL policy, the policyholder's cash value is credited with a portion of the return from a specific market index, often, as in this case, the S&P 500 Index. The credit to the policy's cash value is based on index appreciation over a set period (often one year). The details of how policies are credited are described in the insurance contract, which is typically delivered to the consumer after the policy is issued and the policyholder has paid his/her premium. Prospective policyholders can ask for a sample contract, but in my experience, few do.

In most cases, the participation in the appreciation of an index has a limit or upper level that is called a cap or participation rate. When looking at the computer-generated projections of future cash value, what is often not clearly communicated or disclosed is that the insurance company has the contractual right to lower these caps or participation rates at their discretion.

This has a material impact on what level of returns the consumer will receive from the product. In fact, despite the relative novelty of IUL policies, caps have fallen on most of these products since they were introduced less than a dozen years ago; some as much as 50%, as can be seen in Chart A below.

Also, the insurance companies have the right to drop the cap down to as little as 3% on most products. This means that the cash value crediting can be significantly throttled regardless of the appreciation of the index. Understanding this moving element of caps in an IUL product is critical to understanding the product's main downside risk.

# IMPACT OF CAP CHANGES ON CREDITS



Annual S&P 500® Total Return from 2010 through 2020. Cap versions use the S&P 500® Price Return which excludes dividends and assume a 0% floor and no asset fees.

\*Chart A: Impact of Cap Changes on Credits. Chart created by Valmark.

When these products were introduced, and when the policy in question was sold, caps were much higher. Caps are fundamentally based on market forces of an options budget and rely on what insurance companies can earn on their portfolios as well as the market cost of options. The more money that's available to spend on options and the lower the options pricing, the higher the caps that can be offered in the policy. When insurance carrier portfolio rates drop, and/or option prices go up, the carriers generally lower caps.

## Future Expectations

As much as caps have declined thus far, future projections from today are even more sobering. The defining aspect of indexed products is that they have upside potential without the downside risk. When the policy in the example was issued the cap rate was 12%, and that allowed a significantly higher crediting rate. AG-49 wasn't implemented until later in the same year this policy was issued but the illustration suggested the policy could be projected at 7.68%, not unusual at that time. The sales ledger was actually run at a 6.25% projected crediting rate, which would have been more in line with the upcoming regulations and likely seemed relatively conservative.

However, this policy's cap has since come down, as has the cap of almost every IUL product in the market. The cap on this contract today is 8%, and this reduces the allowable projected rate to 5.18%. When you take all the market returns over 8% off the table, the realistic return must come down substantially. If the cap is further reduced, as experts believe will happen in the future, the crediting rate will also be reduced accordingly.

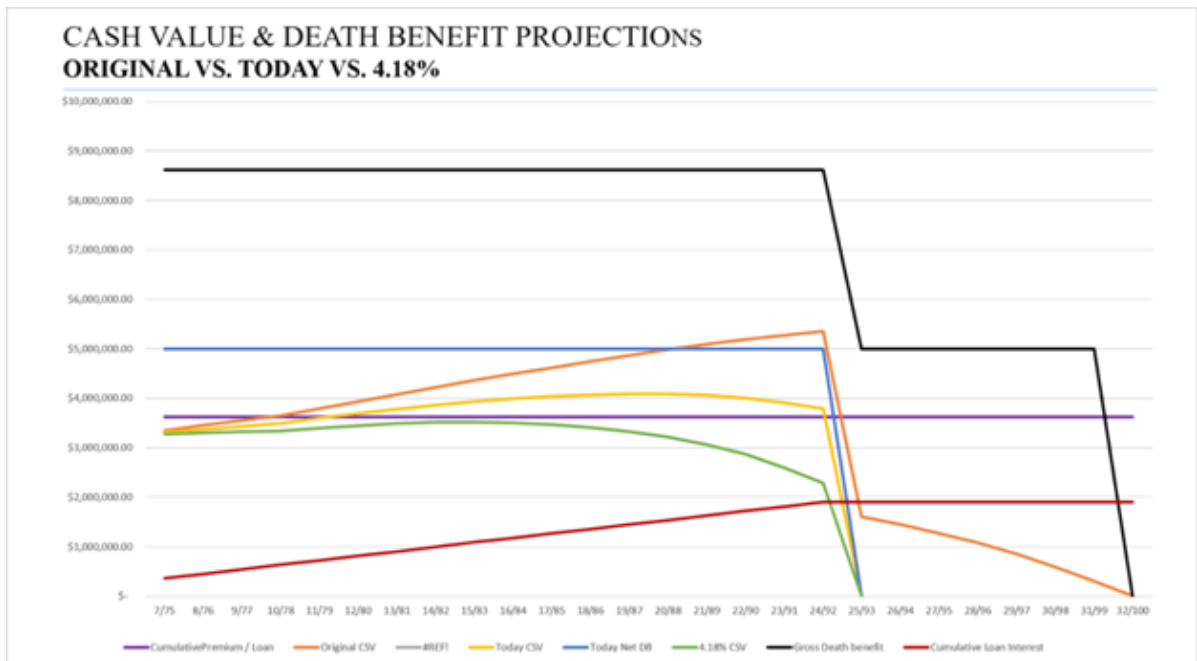
To put this into context, we recently reviewed a policy where the current cap rate is *lower* than the original projected crediting rate. That original rate was a few hundred basis points *higher* than it is now and hundreds of points *lower* than the cap rate at that time. I imagine most people never thought that would be a reality.

## 1990 – 2020 S&P 500

S&P 500 Total Return	S&P 500 Index today	12% Cap	10% Cap	9% Cap	8% Cap	7% Cap
10.70%	8.37%	7.28%	6.48%	5.93%	5.35%	4.76%

The table above is a simplified version of the AG-49 regulation. We took the actual S&P 500 data from 1990 through 2020 and show the total S&P 500 return, the S&P 500 Index return without dividends, and what the return would be over the period with a 0% minimum crediting and the assumed cap. This is simply a bracketed return over the most recent thirty-one years of the S&P 500. What is very interesting is that using only these 31 data points, our calculations are amazingly close to the AG-49 numbers that use over 10,000 data points going back 66 years.

The 12% cap rate is only a fraction of a point off what we saw in the original sales ledger. The 9% and the 8% cap numbers are even closer with our calculations, and the current max crediting rate is separated by only 17 basis points. If all those numbers line up, along with all the numbers we have ever calculated for any other analysis, we are going to assume our 7% cap number will be just as on target. If the cap goes down another one percent it would have a further major impact on the policy performance. The graph below captures what things would look like if the rate goes down even more.



While the policy appears to be only slightly off track today (orange vs. yellow cash value lines), updated projections for this policy over the coming years and decades show the cash value to be considerably reduced. The death benefit is still in force, so one could argue, what's the issue? The original proposal assumed that the cumulative loans of over \$3.6 million (purple line) would be repaid with a withdrawal of cash value from the policy (represented by the orange line dropping in policy year 25), leaving enough cash value to power the policy on into the future (orange cash value line supporting black death benefit line).

So far, for the subject case, the original projections from 2015 aren't that far off from reality. Several great years of returns for the S&P 500 have propelled the cash value close to where it was projected to be at this time. But going forward, the lower caps indicate the policy to be veering off course with almost no chance of meeting initial projections. As a result, the client will have purchased a very expensive insurance policy that must be canceled in order to pay back the bank loan and, depending on policy design, might be hit with an unexpected tax bill.

At the 5.18% projected crediting rate, the policy will not have enough money to fund itself. Essentially, all the cash value will be used to pay back the loan, and the policy will lapse (yellow cash value line going to zero and pulling the blue death benefit line along with it). Along the way, millions of dollars of loan interest already paid (red line) will have been lost. If the rate is lowered further, or if actual market performance is not as forecasted in the projections, even the posted collateral could be in jeopardy (the seven figure spread between green cash value line and purple loan/premium line that would've been covered by outside collateral).

It is important to further understand that 5.18% is the maximum regulatory allowable crediting rate per AG-49 / 49A. This crediting rate is based on a geometric mean of thousands of data points over many years, which means the 5.18% itself is, in the big picture, a 50/50 proposition. This is also based on the insurance company's earning 45% annually on its options, one of the most controversial assumptions under AG-49A!

### **What Does This All Mean?**

The bottom line? If the client purchased this policy because he needed the coverage and he's making 20% on his invested assets and needs only a liquidity event in the future to pay back the loan and skate away with the balance after taking advantage of positive arbitrage, well played.

But this wasn't the case and it's rarely how we see it positioned. Premium financing is often postured for sophisticated people who use other people's money to stay fully invested. There is nothing necessarily wrong with that, but we almost never see it described as playing the spread between borrowing rates and the opportunity cost of money. It's always about the spread between borrowing rates and the supposed crediting of the cash value.

A closer look at the transaction in the example shows us that after five premium payments of \$517,000, the cash surrender value was projected to be \$2,212,248. That's a rate of return of negative 5.15%. The projected return at the end of 10 years is 0.10%. At the end of 20 years, it's 1.89% based on a continuous crediting rate of 6.25%. The rate of return on premium to cash value is less than any conceivable borrowing rate, so the critical question is where's the arbitrage?

At the current, lowered maximum crediting rate, the 20-year return is .715%, and that's after incorporating the high returns of the first half dozen years of the policy. Moving forward from today, with the high early year policy expenses already paid for, the 5.18% projected crediting rate results in a 1.32% growth at policy year 20. Given the internal machinations of the policy, the S&P 500 will likely have to perform on an even keel and in the double digits indefinitely to hold to the newer, reduced projections with no further (and likely) reductions in the cap rate.

The real story, as opposed to the marketing story, is sobering because immediate action is necessary. However, in our experience, we see very few instances of promoters raising these issues with their clients. In fact, when we see any attention paid to this it tends to be rather evasive or even doubling down on the strategy even though the numbers prove futile.

## **Help Is Desperately Needed**

What the market needs is independent analysis and ongoing monitoring by someone other than the promoters who sell these transactions. Because the cash values right now are generally not too far off from what was projected, no alarm bells are going off. What we often see presented to others in the market today isn't any different than this illustration from 2015. Some are better, some are worse, but they all have something in common; IUL policies are all built on the same foundation and that foundation is constantly shifting and substantively misunderstood.

Cap rate reductions are having a significant impact on policy performance, and they will continue to do so. The new AG-49A regs that affect new policies, but not those in force before 12/14/2021, leave a vast majority of indexed contract owners relying on projections that regulators have effectively declared misleading and too aggressive, but IUL contract owners may have no knowledge of this.

As with everything regarding the time value of money, the longer one waits, the better or worse things will get. If you are experiencing 10% returns in your stock portfolio over time and you have enough of a runway to realize it, those exponential returns are going to benefit you greatly. However, if you are on the wrong trajectory, these same fundamentals will instead work against you. In other words, if you are underwater now, waiting will only make it worse. If an honest evaluation indicates future problems, damage may be minimized or reversed by discovering and addressing these issues as soon as possible.

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

Bill Boersma