BROKER WORLD

Why Policyholders Need to Consult with an Insurance Specialist!

PETER KLEIN, CFA

is director of advanced markets and underwriting at Secor Advisors Group, LLC, and Brendanwood Financial, with more than 25 years of experience in life products, wealth management, estate and retirement planning, and alternative asset classes, including life settlements.

Klein started his career with Travelers Insurance Co in investment management. During his tenure at Travelers, he attended life insurance school, receiving extensive training in life insurance products. He has advised corporations on keyman policies, corporate COLI plans, andpremium finance including policy reviews.

For the last several years, Klein has provided consulting services to life insurance general agencies and independent marketing organizations. He holds two graduate degrees, an MS in science and an MBA from the University of Connecticut.

Klein can be reached by telephone at 317-414-1205.

The days of buying a life insurance policy, paying the same annual premiums, and putting the policy away in a safe deposit box are over. There are two converging factors leading to greater uncertainty in the retention of long-standing life insurance policies.

Life expectancies used to project policy performance have proven to be too short. First, people are living longer. In some cases, a lot longer. Advances in medicine, including preventive care and new treatments for heart disease, have combined to change the leading cause of death from heart disease to cancer. Decades ago, most insureds dismissed the prospect of living to age 100. Consequently, most policies purchased were only illustrated to run to age 85 or 88 based on a woefully inadequate funding scenario.

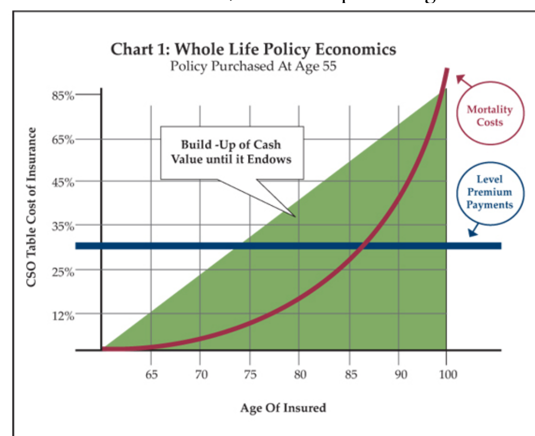
Carriers are unilaterally raising premiums on policies sold decades ago. The second factor is that major insurance carriers are breaking a long-standing tradition by raising rates on life insurance policies that were sold to consumers decades ago. This is a fallout from prolonged low interest rates. A review of historical interest rates have to go back to post-war 1950s to see rates this low.

Industry analysts say most insurers have cut expenses and taken numerous steps to manage profitability over the years, but now they are running out of options. Since insurance companies don't get to pocket the premium paid to them, carriers rely on the earned investment income from premiums collected. Unfortunately, years of low interest rates have squeezed investment income, which has pressured carriers to improve their margins. This means that, with certain products, some people in their 70s and 80s are facing substantially higher charges for their life insurance purchased decades ago. The escalation in charges could be just the beginning, with higher charges for potentially millions of Americans on certain types of policies. In some cases, the combination of escalating premiums with the realization that the insured could live to age 100 or beyond has resulted in a capitulation by some policyholders and an increase in lapse rates.

How Do Carriers Get Away with Escalating Insurance Costs? The short answer is they don't. Carriers must gain approval from each state's department of insurance for products offered. This is both expensive and time-consuming. The products have designated Common Standard Ordinary (CSO) tables referenced in their contracts that provide maximum allowed mortality charges. Typically, the carrier only charges a fraction of the table's annual mortality rates. In recent years, carriers have opted to charge a higher percentage of CSO table rates, and their right to increase rates is clearly disclosed to customers in policy agreements. In some case, I have seen carriers double the percentage of mortality cost used in determining monthly deduction, even for policies that have been in force for decades.

Primary Life Products Impacted

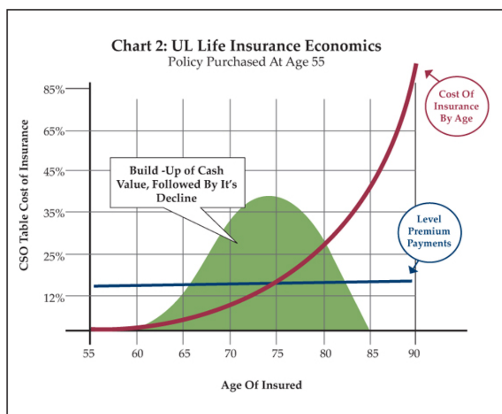
There are two broad categories of permanent life insurance products, whole life & universal life. The original permanent policy was whole life, or "straight life,' which obligates policyholders to pay premiums typically to age 100, when it endows. As graphically illustrated, the policy owner pays level premium (illustrated by the flat black line) where the cash value at maturity (illustrated by the green line) is equal to death benefit. The red illustrates CSO rates, which steepens at age 80.



In the mid to late '70s, a new generation of policy known as universal life (UL) came to the market. For a permanent policy, this product offered a lower, more efficient premium obligation relative to the size of the death benefit provided, but it came with some risk since the endowment guarantees were not there and the policyholder had to accept mortality and interest earnings risks. Consequently, these policies required illustrations based on funding scenarios determined by the agent and client. These assumptions became even more refined by assuming a finite number of level-premium payments with future monthly deductions being paid from a steady drain on the life insurance savings account or cash value.

Decades ago, these policies used interest rates of 6% to 8%, considerably higher than the rates guaranteed in the contract. It was assumed the insured would live to 85 or 88, at which point only minimal cash value needed to be present in the account. These assumptions allowed for relatively economical premium payments. It is for these reasons that UL policies were typically used when a large face value was required, as in key man policies or in substantial estates. While UL polices do not technically endow in the sense that whole life policies do, they require routine monitoring and timely re-evaluation.

Over the years, multiple types and generations of UL products have evolved. A typical current assumption UL product can be illustrated by the graph below. In this ideal scenario, the insured lives to age 85, and historical interest rates of 6.0% or better prevail. Low-level premiums are consistently paid from a buildup in cash value and decline to zero at age 85, when the policy's death benefit is realized.



Alternatively, if the insured lives to policy maturity (ranging in age 95, 100 to 110), the UL policy will pay out only the cash value remaining. Assuming the client has a $1 million policy and lives to age 100 with a cash value of $300,000, he then gets a check for $300,000, while a balance over tax basis would be taxed at ordinary rates. Certain types of guaranteed policies can take the cash value at maturity and extend it as the new death benefit, while some guaranteed policies allow the full benefit to stay in force until death, regardless of age. A typical guaranteed policy's maturity is more likely to extend to age 112, 118, or even 120, but the client has to choose how long to fund it. Another benefit of guaranteed policies is that the premium can be locked in for the extended maturity date. Yet once the guarantee is lost due to late payment, the premiums are free to escalate. I have witnessed annual premiums doubling or tripling in such cases.

Life Expectancy

Understanding the insured's life expectancy (LE) is essential in determining if the policy is guaranteed past LE and whether the policy is economical. Estimating how long the insured will live requires considerable study, but there are firms that specialize in estimating life expectancies using algorithms based on 40 years of history in scoring LEs and tracking subsequent death outcomes. An LE's accuracy is contingent on the law of large numbers, involving portfolios of 200 or more lives. Since we are dealing with the life of one individual, accuracy is substantially less. Nevertheless, the exercise provides a relative perspective on longevity compared to that individual's specific peer group.

The customized mortality table produced by an LE report gives probabilities of death at different ages. We can apply these probabilities against updated and revised projected premiums modeled for the policy to calculate relative returns.

Policy Options and Tax Considerations

Timing is of the essence in developing alternative solutions for a client. You have to have sufficient lead time given the client's budget constraints. Even if the policy is auto loaning its premium payments, the amount of available cash value is finite. Further, the insured's underwriting status of standard or better is also finite. The client needs to rationalize their budget and their ability to cover future escalations in premiums.

The tax consequence of making changes or cancelling a life insurance policy cannot be ignored. The presence of cash value complicates things; the difference in tax basis versus cash value will result in taxable income in the event of terminating a policy. Alternatively, in the event the client elects to sell the policy in the secondary market, the proceeds up to the cost basis are tax free, and any additional money up to the cash surrender value is treated as ordinary income. Any value in excess of the cash surrender value is taxed as capital gain. The options available to a policyholder are numerous and complicated from the perspective of an insurance specialist. Therefore, policyholders who are left to their own devices are likely to disadvantage themselves.

The Importance of a Policy Review

Most clients have minimal understanding of their policy. They may not even know which type of policy they own. The combination of escalating premiums with changes in longevity requires a routine review of UL policies. Educating the insured and their financial professionals can often result in a timely call to action.

Most clients' financial lives are based on a tightly scripted budget, and any change in the trajectory of future expenses can have a profound consequence.

To be competitive, carriers typically assume lower future operating expenses and higher interest rates in generating illustrations at the time of sale. Consequently, the base case is always the most optimistic in projected outcome. The reality is that the original illustration will likely fall short. The question is to what degree?

From annual statements, we can determine current revised monthly deductions compared to past monthly deductions charged. Sometimes we can approximate the percentage of CSO table rates being charged and the potential for escalation. A policy review can produce new illustrations to help clients better understand the trajectory of the cost of insurance and potential rate increases. With the right analysis and planning, a client's policy can continue to work in your best interests. The key is to act now, before it's too late.

Insured's Status	Policy Transaction	Policy Payout	Tax Basis
Dies	Before Policy Matures	Death Benefit Paid	No Tax Event
Lives	Past Policy Maturity Date	Policy Endows	Taxable
Lives	Policy Has Maturity Extension Option	Policy's Maturity Extended	No Tax Event
Lives	Replace—1035 Tax Free Exchange	Exchange Policy for a Guaranteed Policy	No Tax Event
Lives	Elects Premium Finance Option	Borrows to Pay Premiums*	Unpaid Loans—Taxable Income
Lives	Sells Policy—Secondary Market	Security Transaction	Taxable

*Even if the loan is non-recourse and the loan is not paid, it becomes taxable income to the borrower.

Case Example 1: Male age 85, $20 Million Keyman UL Policy

Insured male, age 85, involving a keyman $20 Million UL policy with return of premium rider and $5.0 million in cash value.
The policy endows at age 100, while annual premiums are in excess of $1.0 Million. The existing cash value is projected to hold the policy for three to four years, at which time the contract would lapse. Recently, the carrier almost doubled the monthly deductions from an estimated 26% of CSO table rates to 45%.
The policy is currently funded by a steady drain from the policy's cash value. Prior to that, premiums paid for the last 11 years had been entirely financed with interest accrued.
The essential risks are that the insured's unexpected longevity (substantially longer than originally assumed) could persuade the carrier to unilaterally double the premiums again and still be within the CSO guidelines on the policy. The loan including accrued interest was growing at a velocity that could surpass the death benefit in the not too distant future. We conducted a policy review and engaged a life expectancy analysis on the insured to determine the best option. Conclusion: There was a significant risk that the insured could live to age 100 when the policy endows, while the loan balance would continue to escalate and substantially overshadow the balance available when it endows.

Case Example 2: Male age 87 $1.0 Million GUL Policy

I was engaged by a life agent whose client, an insured male, age 87, had a policy $1.0 Million GUL with minimal cash value. The policy was acquired for estate planning purposes. It's a guaranteed policy to age 110 with an annual premium of $25,000. The client has been paying the same premium for the last 13 years.
Recently, he has been bombarded by the carrier for additional premium payments under the threat of the policy lapsing. A review of the annual statement and updated illustrations showed that the policy had lost its guaranty. This allowed the carrier to charge prevailing premium rates. The premiums had gone from $25,000 to $87,000 annually. The client had missed a quarterly premium payment, which resulted in the policy losing its guaranty.

Retired and living on a fixed income, the client could not afford the substantially higher premiums, allowing the policy to lapse was also not an option. The insured had a history of recurring non-cancerous brain tumors. A life expectancy evaluation was done, which was used to determine maximum financial exposure to future premium obligations. Conclusion: The client's probability of living past a threshold of years was less than 20%. A new budget allocation would allow the insured to meet future premium obligations and an 80% probability of payout.