

UNIVERSAL LIFE SECONDARY GUARANTEES

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Several years ago a few life insurance companies began to introduce the concept of “Secondary Guarantees” to universal life insurance contracts. This produced a guaranteed death benefit for a specified period of time, or even for life, at a low premium, generating very low cash surrender values. Initially they were used in Second-to-die contracts since this policy type is almost always used for Estate Tax liquidity and advisors rightfully argued that being able to produce a guaranteed, lifetime death benefit for a low premium was more important than creating cash values. Soon this concept moved to single life UL policies, followed by most insurance companies in this market waiving all policy charges when the insured attained age 100. A lifetime guaranteed death benefit at a fraction of the premium charged for whole life, the only policy that previously offered this benefit, had great appeal.

During the past 24 months Secondary Guarantee warfare has broken out. Companies that have chosen to compete in this market have lowered their costs for lifetime guarantees. On the other side of the debate are those carriers who call “foul” suggesting doom and gloom for their competitors that are in the game. This paper is for life insurance agents looking to provide their clients with objective advice pertaining to the use of these contracts.

The Concept

Prior to Secondary Guarantees it was often impossible, or at best very expensive, to produce a premium in a UL contract that would provide a lifetime guarantee. This concept stipulates how this might be accomplished without forcing high premiums and cash values. This guaranteed premium is usually accomplished based upon one of two calculation methods:

Stipulated Premium Method

Early versions of UL contracts with Secondary Guarantees stipulated a premium that, if paid on a cumulative basis, would guarantee the death benefit to the insured’s age 100. If the contract provided a Secondary Guarantee for less than the life of the insured, say for 15 or 20 years, then there would be a stipulated premium required for each of these time periods.

An example of this might be a policy stipulating that a \$500 monthly premium is required for an age 100 guarantee, while a 20 year guarantee would require a \$300 monthly premium. Seems simple enough, but the astute agent has many more questions to ask and the consumer must understand his/her rights before proceeding.

Here are the questions that must be asked and answered:

1. What if the \$500 premium is not paid every month? Can the age 100 guarantee be re-established? Assume that the cumulative paid premium at the end of 240 months is \$100,000. This is \$20,000 short of the amount required for a lifetime guarantee ($240 \times \$500 = \$120,000$). At this time if the policy owner wants to be assured of a lifetime guarantee and is willing to pay a “catch-up” premium, is it allowed?
2. If the answer to number 1 is yes there are two qualifying questions that must be addressed. Can the “catch-up” take place at anytime while the policy is still in force, or must it be within a stipulated time frame following the point that cumulative premiums fell behind the minimum? And, is the “catch-up” amount merely the total difference between the sum paid and the cumulative premium requirement, or is an interest element added? “Catch-up” without interest and with no time limitation is best for the consumer. If this were the case, in our above example only the difference between \$100,000 and \$120,000 would be required followed by an ongoing monthly premium of \$500.
3. Finally, if cumulative premiums exceed the stipulated amount necessary for the Secondary Guarantee will any discount factor be applied by the insurance company giving credit for the use of money thereby reducing the cumulative requirement?

The stipulated premium method is the simplest Secondary Guarantee method to understand, but it does not necessarily produce the lowest guaranteed premiums and it is not as prevalent today as the next method to be described. However, even with a higher premium, a stipulated premium method that provides “catch-up” at any time with no interest can be very appealing to those wanting to invest their own money while minimizing their outlay to the insurance company for lifetime guarantees.

Shadow Account Method

The shadow account method of providing Secondary Guarantees has been more prevalent in recent policy design. There is no specific premium stated in these contracts. Instead the contract maintains a “shadow” cash value account based on credited interest that is higher than the policy’s minimum guaranteed interest and COI rates that are lower than the policy’s maximum COI’s. As long as this shadow account remains positive, the secondary death benefit guarantee remains in force.

Although these shadow account interest rates and COI’s are guaranteed by contract the cash value produced is not available to the policy owner for any purpose other than to maintain the death benefit. Thus, the policy ledger might show zero cash value under the guaranteed column, or even under the current column, while continuing to guarantee the full death benefit.

The shadow account method can produce a death benefit guaranteed for any period of time. The illustration system will calculate the premium required to maintain the shadow account in a positive position through the year for which the death benefit guarantee is desired. This premium will not be stated anywhere in the policy, but will be defined by formula that supports this illustration. However, illustrations assume premiums are paid on the date due and since actual interest is credited from the date they are received, the shadow account could be placed in a negative position unless premiums are always received on, or before, their due date. Backdating a policy to save age and 1035 exchange funds not arriving on the policy issue date can also produce an illustration with an understated premium required for the Secondary Guarantee.

As with the “stipulated premium” method, the question of “catch-up” also arises with shadow accounts. In most of these contracts re-establishing the secondary guarantee may take place at any time by bringing a negative shadow account into a positive position just as long as the policy is still in force on a current basis. However, as time passes the amount required to reverse a negative shadow account to re-establish a positive position can become ominous. Premiums imposed must make up for lost interest and the effect of COI charges being imposed on a higher net amount at risk.

If a lifetime guarantee is important to the client, the agent recommending the “shadow account” method using a projected premium pattern that is less than the amount required to continually maintain a positive shadow account has a responsibility to inform the client of the amount of premium needed at various points in the future to re-establish the death benefit guarantee.

Cost Waivers at age 100

As stated in the first paragraph, most insurance companies offering Secondary Guarantees also waive all costs after the insured, or youngest insured in a second-to-die policy, reaches age 100. With many more people reaching the century mark, this has become important especially for the estate planning case.

Most of the policies designed today simply state that if the policy is in force at this age, then all future policy charges, including COI's, will be waived and the policy's death benefit will remain in full force. However, some of the earlier versions required that the policy must not only be in force, but there must also be a positive cash value at age 100. This is not “shadow” value, but actual cash value. Agents must be aware of what method is used since most of these policies reaching age 100 will do so based on secondary guarantees and there will be no cash value at that time.

Are Secondary Guarantees Good for the Consumer?

So, what's the catch? How can death benefit guarantees not be good for the consumer? Of course they're good for the consumer! But there's more to it. Buyers must be aware of potential pitfalls.

First, the consumer must understand exactly how the secondary guarantee operates in the policy that has been purchased. He/she must realize that if the premium required to provide the Secondary Guarantee is not paid on a timely basis, even though the policy may still be in force, the Secondary Guarantee may not be recoverable, or if it is the "catch-up" premium—with interest—may be exorbitant.

Next, the financial strength of the issuing insurance company must be questioned. But shouldn't this *always* be an important consideration? The answer is "yes", but there are two reasons why this becomes especially important in these types of sales. Some are saying that the pricing on these Secondary Guarantees is just too good to be true. According to these critics even when applying aggressive interest, mortality and lapse assumptions, the issuing carriers will ultimately lose money on these policies.

Others are saying that there has not been sufficient reserving established for these contracts and it may be necessary to increase reserves to a level that was not taken into account in the policy's pricing. In an attempt to skirt this issue, some carriers may have established foreign sites to reduce their reserving requirements. This could be challenged by insurance regulators.

If either of these allegations proves to be true there could be a negative financial impact upon the carriers whose secondary guarantees are priced most aggressively. This is not to say that consumers will lose their contractual guarantees. As long as the companies issuing these policies remain solvent, the policy guarantees will be honored. If the company issuing these low cost secondary guarantees is financially sound and of adequate size so that the proportion of premiums being written on these new policies does not overwhelm their asset base, then consumers should feel comfortable taking advantage of these low priced guarantees.

Timing is Everything

Secondary Guarantees in universal life policies are a feature whose time seems to be right. Many universal life policies were sold years ago with the anticipation of high interest earnings. Many whole life policies sold at the same time used unrealistic dividend projections.

So, at this time we find many people who will outlive their insurance policies. Often these people feel as though they have been burned and they don't want to be burned again. They have an option to increase the premium in their current policy, but even that won't guarantee the death benefit. Guarantees look very good to them.

With today's Secondary Guarantees it is often possible to issue a new policy under a 1035 Exchange and produce lower premiums with lifetime guarantees. What's

wrong with that? Here are the concerns. Insurability must be determined and no existing policy should ever be discontinued until a new policy has been issued and put in force. The new policy's acquisition costs and basic policy design will result in lower cash values in the new policy. This may be of little concern if the emphasis is on guaranteed death benefit, but it is important to remind policy owners that if they discontinue coverage in the future then the policy's cash value could be very meaningful. And finally, a new policy will have a new contestability and suicide provision. This information must be put in writing to the policy owner by the agent when replacing any policy.

Summary

Secondary guarantees in universal life policies can be very attractive for those seeking long term death benefit guarantees where cash value is of little importance. It may be true that some of these policies being issued today will prove not to be profitable for the issuing companies and might create surplus strain in the event that they are not being adequately reserved. Some of the provisions of these policies can also be very confusing and if not properly understood, the consumer could ultimately lose the guarantees.

With all of this said, Secondary Guarantees will appeal to, and be appropriate for, a defined market. Consumers who need permanent death benefits guaranteed by financially sound insurance companies at low premiums, have many interesting options from which to choose. Although some liken this product to the commoditization of term insurance, it is much more than a "spread sheet" sale. It does require the services of an objective, well informed insurance professional who is willing to take the time to understand the market.