Current Trends in Life Insurance Choices and Strategies

The low interest rate environment and the high estate tax exemption amount have each had an impact on the insurance component of estate planning.

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The life insurance industry is undergoing another inflection point in its evolution. Due to a combination of investment, regulatory, and tax reasons, life insurance companies are reorienting their product offerings to satisfy consumer demand and maintain profitability. U.S. life insurance companies are rotating away from death-benefit-only products in favor of more cash value accumulation products that feature greater flexibility.

Take a step back, and walk through recent history of life insurance product development:

- In the 1970s, term and whole life were the only products available in the retail market.
- As interest rates rose in the 1980s, current assumption universal life (UL) products emerged to capture the rising interest rates earned on fixed-income investments.
- By the 1990s, equity markets boomed, and life insurance sales captured this trend as variable UL (VUL) sales expanded.
- As we entered the 2000s, interest rates continued to decline as did equity markets. Wary customers seeking reduced investment risk turned to no-lapse guarantee (NLG) UL products to reduce volatility and complexity in their life insurance portfolios.
- As interest rates remained persistently low, and with the increased reserving imposed by state regulators on NLG products following the market crash of 2008, carriers were forced to either abandon the NLG market or increase their prices.
- Most recently, carriers have turned to a relatively new product, indexed UL (IUL), to create increased yield and risk through indirect exposure to the equity markets.

For the ultra-affluent, reducing estate taxes and overall wealth transfer planning remains a key objective. For the mass affluent, the increase in the federal estate tax exemption and portability eliminated federal estate taxes as the dominant motivating factor to purchase life insurance through an irrevocable life insurance trust (ILIT). Now, state estate taxes and higher income taxes, along with a host of nontax factors—such as estate equalization, second families, business planning, and asset protection—all justify the use of life insurance by the mass affluent market.

Term insurance

Personal sales of term insurance are sparse in the ultra-affluent mar-

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ket because the estate planning need is permanent. However, illiquid family business owners without an exit strategy may use term life insurance as a liquidity stop-gap in the event of an untimely death. Business owners continue to use term as a way to protect against the death of key employees (i.e., key man insurance arrangements) and as a way to maintain ownership and minimize potentially liquidity calls due to the death of a fellow owner (i.e., in conjunction with buy-sell agreements). Most commonly, term insurance is used in the mass affluent market to protect against a time-limited need (e.g., income replacement, mortgage, and other liabilities).

Whole life insurance

Carriers have revamped their whole life product lines. Years ago, whole life insurance was the only permanent product available, and offered a guaranteed death benefit for life. An insured paid the premiums and was promised a specific base amount of coverage for a certain number of years. Today guaranteeing a premium is very expensive for a carrier. Although whole life premiums will be higher than all other permanent insurance products, the insured is able to accumulate guaranteed cash values and then borrow or withdraw on favorable tax terms. Alternatively, the insured can surrender the policy recovering premiums and growth (less taxes).

Whole life may be desirable as a tax-efficient forced savings strategy for the mass affluent. Very wealthy individuals prefer the flexibility and lower costs of UL products such as NLG and IUL policies.

NLG UL insurance

Today life insurance companies are shifting their marketing efforts away from death-benefit only products and towards hybrid or combination products that include robust cash accumulation. Persistent and extended low interest rates and stricter reserving rules require life insurance companies to charge higher premiums for new lifetime NLG coverage. Some companies have discontinued issuing new NLG policies altogether. Demand from younger clients is forcing life insurance companies to offer less expensive, more flexible policies that allow for lifetime exit strategies.

Absent meaningful cash value, there is no flexibility or exit strategy available to convert a typical NLG product to a different type of life insurance product.

In addition to the prospect of weak returns from historically low interest rates extending over an unusually long period, the National Association of Life Insurance Commissioner's (NAIC's) revised Actuarial Guideline 38, adopted in 2012, requiring insurers to hold greater reserves on both new and some existing NLG policies. This has dampened the NLG market. Carriers anticipated that interest rates before the 2008 financial crisis could decline, but not to the extent they actually have and not for as long as they already have.

To address the fact that money reserved for NLG policies as well as new premiums cannot be invested at the original interest rate assumptions, the revised AG 38 guidelines require higher reserves both for new NLG policies issued in and after 2013 and certain in-force policies issued after 7/1/2005. In the case of existing NLG policies issued before 2013, the new AG 38 rules do not allow the carriers to change the guaranteed premiums on in-force policies. This means higher reserve contributions on existing policies must come from current carrier earnings. Some carriers will try to offset the increased reserve requirements for in-force NLG policies by adjusting (increasing) pricing on non-guaranteed policies. By 2013, the NLG market share had dropped to 25%.

Most estate planning scenarios for ultra-wealthy individuals call for a guaranteed death benefit that NLG products provides. The supply, however, has dwindled and the price has increased. Only agents with access to a wide array of top-rated carrier products can satisfy the diversification demanded by these clients when constructing a portfolio large enough to meet their estate planning needs. Sales are driven by clients seeking fixed pricing and a shift of investment risk to a strong counterparty.

These products are most suitable for risk-averse older clients with shorter time horizons. NLG provides guaranteed lifetime premiums but minimizes cash value and lifetime exit strategies. Planning objectives of younger and middle-aged clients are likely to change over two or three decades, and absent meaningful cash value, there is no flexibility or exit strategy available to convert a typical NLG product to a different type of life insurance product.

Traditional UL—durational guarantees

The underpinnings of current assumption (traditional) UL products are flexible premiums and linkage to the carrier's portfolio general account return expressed through a crediting rate. Carriers are required by state regulators to invest upwards of 80% of their general account in mid-term (ten-year) Treasuries, corporate bonds, and

EXHIBIT 1
Life Insurance Product — Risk Spectrum

High Product Risk ⟵⟶ Low Product Risk

High Product Performance Risk Full Market Exposure	*Hedged Product Performance Risk Limited Market Exposure*	*Reduced Product Performance Risk Carrier Portfolio Exposure*	*No Product Performance Risk Guaranteed Results*
Variable Universal Life & Private Placement Life Insurance	*Indexed Universal Life*	*Universal Life & Whole Life*	*Guaranteed Universal Life*
• Cash values are "invested" in a basket of mutual funds. • Cash values are not subject to claims of carriers' creditors. • Policy owner takes investment risk, and performance is based on investment performance. • Some carriers offer guaranteed riders that allow for both cash value growth and guaranteed premiums.	• Cash values grow based on a specified market index's return. • Cash values are not invested in the market; rather, a small portion buys call options on a specific index. • Carriers set cap and floor and offer guaranteed caps and floors. • Some carriers offer guaranteed riders that allow for both cash value growth and guaranteed premiums.	• Cash values are invested by insurance carrier in bonds and mortgages. • Cash values are subject to claims of carriers' creditors. • Crediting rates reflect "new money" rates • Carriers offer contractually guaranteed minimum crediting rates.	• Premium amounts and durations are guaranteed and are not interest sensitive. • In essence, it is term to age 100, with carrier taking more performance risk. • Policies designed to have less cash value. • Non-correlated to other assets. • Marketplace is shrinking and/or re-pricing.

NOTES

1. Model only, not an offer or contract. Extracted from typical top-tier carrier illustrations. See full illustrations for all assumptions. If variable, you must receive current prospectus.
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commercial mortgages. Bond and Treasury yields have declined over the last two decades, resulting in current crediting rates on UL products today resting in the 3.5% to 5.0% range. As equity markets have steadily risen since 2008, VUL and IUL products offer greater yields to those policyholders seeking near-term upside equity participation. It is no surprise then that traditional UL sales have declined from nearly 40% of total life sales in 2007 to 20% by 2013.

Life insurance companies have responded by offering traditional UL policies with a durational guarantee (usually to life expectancy) with some cash value growth. The durational guarantees require far less reserving and yet provide fixed premiums until roughly age 88 to 92. With no secondary guarantee fixing premiums for life and carriers' reserving far less on their balance sheets, premiums for these durational guarantee products can be much lower than NLG products. The life insurance companies market these products as maximizing the death benefit while minimizing the premiums. The durational guarantee products are illustrated at current assumption (at market) crediting rate while also showing the guaranteed (worst case) scenario. Today IUL and VUL with limited durational guarantees are also available.

The risk with durational or life expectancy guarantees is if the insured lives beyond the guarantee period and the crediting rate has not performed as projected, with the potential result that future premiums will increase after the durational guarantee expires. The client must be comfortable accepting this risk in exchange for cash value accumulation, creating a viable exit strategy, and upside participation should crediting rates increase over the duration of the policy.

UL policies with durational or life expectancy guarantees work best for middle-age individuals who have longer time horizons during which to build cash value. Cash value provides flexibility and an exit strategy should the insured's future needs change. The insured is either able to complete a Section 1035 exchange with the cash value transferred into another product, or surrender the policy and keep the money (after payment of any tax on the surrender).

VUL and private placement life insurance (PPLI)

VUL has become very popular among very wealthy individuals who are also highly sophisticated investors and willing to assume investment risk. This product offers separate accounts for equity, fixed income, and alternative investments and a general account option similar to traditional UL. The client can reallocate tax-free among different investment options as their risk tolerance profile changes. A key factor is that unlike rebalancing a taxable portfolio, reallocation within the VUL policy or a Section 1035 exchange to another life product is nontaxable. Combined with higher income and capital gains rates, the tax-deferred accumulation feature of VUL and tax-free distributions using the withdrawal to basis and loan rules make VUL suitable in the current tax environment, especially in high tax states such as New York and California.

Highly sophisticated and accredited investors facing higher ordinary income and capital gains rates are again exploring PPLI. PPLI allows investors to widen their investment horizon to include non-SEC registered funds such as hedge funds and private equity funds. Wrapping these private non-registered investments inside a compliant U.S. life insurance policy creates income tax efficiency. The insured must be careful to avoid strict investor control rules prohibiting the insured from involvement in selecting or managing the underlying policy assets as well as diversification and liquidity requirements. These customized products can be structured to avoid high early product charges, minimize state premium taxes, and create favorable lifetime policy distribution by avoiding the modified endowment contract (MEC) rules when funding premiums.

In addition, clients and advisors must evaluate the trade-off between taxes on investments and insurance charges in PPLI. Low turnover and tax-efficient assets are often not the most suitable for PPLI, as tax savings may not outpace product charges.

The ideal client for both VUL and PPLI is someone with low risk aversion and a high level of comfort in investing. Older consumers with a shorter investment horizon may look to VUL as a way to pro-actively control premium costs for a prescribed death benefit. For younger and middle-aged clients, both VUL and PPLI are most suited to reduce taxes on investment earnings and should be thought of as a tax-deferred investment allocation.

The life insurance allocation may be sub-diversified with multiple product types to match the client's existing risk/return objectives.

Index universal life (IUL)

The fastest growing product is IUL. This product offers a crediting rate partially linked to an equity index (often the S&P 500 without dividends) selected by the policyholder. Crediting on an IUL policy is capped on the upside at say 10% to 12% in return for a guaranteed floor of say 0% to 2%. Over extended periods, policyholders anticipate outperforming traditional UL policies during a good market segment while obtaining downside protection during a negative market segment. IUL lies between traditional UL and VUL on the risk/return spectrum: less risky and lower growth potential than variable UL and more risky and much higher opportunity for growth than traditional UL.

The sale of IUL is driven by a couple of considerations. The increased cost of NLG and the bad memories of 2008 have left new policyholders searching for a new low-cost death benefit alternative. Similar to VUL and PPLI, as income and capital gain rates have risen dramatically for all very wealthy individuals, some have begun to view IUL as an efficient income tax deferred investment vehicle that allows for tax-free distributions of cash value.

Like any life insurance product, IUL raises various questions and considerations. For example return caps may be reduced to guaranteed minimums of around 3% to 4% at a carrier's discretion (usually based on availability and cost in options markets). Also, mortality and administrative policy charges of perhaps 1% to 2% will be assessed annually regardless of policy investment performance. This means that in a year in which there is a negative index return, the policy could actually have a real loss due to the mortality and other policy charges. It is vital that an advisor find out the pattern of scheduled mortality and other policy charges over the life of the policy.

For example, in an accumulation IUL product, early cash value growth results from a shift of heavier product and mortality charges to the later years of the contract (back-end loaded). These types of policies may be more volatile due to the manner in which insurance charges are assessed on net amount at risk (NAR = death benefit less cash value of a policy). As the insured ages, the NAR is expected to decline, and larger policy charges later in the policy in-force cycle will be assessed on a reduced NAR. But, if projected growth underperforms over an extended period, not only will this result in lower cash values but also higher product charges that further reduce cash values and product performance, a double negative effect.

Many agents illustrate indexed IUL by relying on a constant aggressive growth rate over an extended period. These projected illustrations are not reflective of actual performance. Advisors must ask for multiple illustrations that include sequencing risk:

- What if the policy underperforms in the early years vs. the later years?
- What if the policy underperforms for one year vs. three consecutive years?

The industry consensus is that IUL should be illustrated at anywhere from 100 to 200 bps above a traditional UL product's crediting rate. If a current crediting rate is 5% then a conservative illustration of IUL could be centered at 6%, but with illustrations on both sides showing 100 and 200 bps over and under performance.

If the client anticipates taking withdrawals from the policy, these expected policy distributions should be included in the illustration. The industry is working through the NAIC to develop a standard for IUL policy illustrations. Carriers in the IUL market and those who are not in this market are attempting to compromise on acceptable requirements when illustrating IUL products.

The ideal client for IUL is someone with moderate/low risk aversion and a comfort in investing in equity markets. IUL offers the same flexibility and cash accumulation as traditional UL but defines the policy crediting rate differently. IUL offers clients the choice of having their long-term investments linked to an equity index with a cap and floor instead of market interest rates as with traditional UL.

Riders/benefits

A common premium design strategy with cash accumulating policies is to use larger than necessary premiums in the early years of the policy to expedite the tax-free growth of cash value. In addition, the use of a cash enhancement (CE) or high early cash value (HECV) rider will spread agent commissions over several years to maximize early cash value growth. Surrender charges in early years may be eliminated. Underperforming existing policies, premium finance cases where collateral is needed, and executive compensation requiring strong cash value on the company's balance sheet are all valid reasons for using these riders.

Return of premium (ROP) coverage maximizes the internal rate of return on UL policies. ROP can be a rider or paid as a death benefit option. The ROP feature returns the premium outlay that a client has paid over the life of the policy by providing an additional death benefit up to 100% of premiums paid. ROP is often used in premium finance cases to ensure a minimum death benefit is paid to the beneficiaries net of loan repayment. Similarly, ROP may be used in split-dollar situations to assure adequate repayment of premium advances on termination of the split-dollar agreement at death.

A long-term care (LTC) rider allows the medical and health care costs incurred during life to be accelerated and paid from the death benefit. In order for the insured to qualify to receive the LTC benefit, he or she must be diagnosed as chronically ill. A physician or other health care provider must certify that the insured is unable to perform at least two activities of daily living or requires supervision due to severe cognitive impairment. Once certified, the insured can start to receive the LTC benefit by accelerating the death benefit. Similarly an accelerated death benefit (ADB) rider allows access to a portion of the policy death benefit during the insured's life once diagnosed with a terminal illness. These proceeds do not need to be used for medical costs, and can be spent for any purpose.

Conclusion

The life insurance industry has dramatically evolved over the last 40+ years, and today there are more product options than ever before. Life insurance companies continue to create products in response to consumer sentiment, marketplace competition, and overall economic conditions. Over the last five years, there has been a shift away from guaranteed death benefit oriented policies in favor of cash-accumulating policies. As life insurance companies have looked for competitive advantages in pricing, they have developed products linked to equity indexes.

In today's diverse marketplace, it is important for advisors to understand the risk and return options available to their clients. Only those agents with access to the entire life insurance marketplace will be able to provide the best product available for each product type. Often advisors spend years getting to know their clients and developing fine-tuned investment policy statements (IPS) with risk/return objectives and relative constraints. With the product choices available in today's life insurance market, product suitability should use the same criterion as other investment allocations. The life insurance allocation may be sub-diversified with multiple product types to match the client's existing risk/return objectives. Alternatively, the life insurance allocation can complement and further diversify a client's overall portfolio. ■