FEATURE:
INSURANCE

By **E. Randolph Whitelaw** & **Henry Montag**

The Life Insurance Policy Crisis

A new era of thinking is needed, and it starts with informed intervention

Do you read, speak and understand "life insurance?" This seems like an awkward question, but life insurance is a financial asset foreign language that requires a problem-solving interpreter to understand. Consider:

- There's a lapsing flexible premium life insurance policy crisis that's been predicted for the past 25 years due to reasons that are easily understood and just as easy to avoid—why has nothing been done about it? After years of timely premium payments, why is lapse without value in the best interest of any policy owner?
- Every week, informed media articles in major publications address the increasing cost of insurance (COI) charges applied to flexible premium non-guaranteed policy types, the resulting adverse impact on policies insuring seniors and the need for credible intervention to avoid policy lapse without value and an unnecessary planning calamity. Given this call to action, why does inattention persist?
- Life insurance agents are held to a suitability standard and, arguably, a fiduciary interest—does lapse document a prudent suitability determination that's in the client's best interests? What was the basis for the agent's product recommendation? What policy risk disclosures were made? Were risk mitigation options explained?
- Litigation, including class action lawsuits, is escalating along with allegations of misleading and deceptive marketing practices. What are the specific deceptive practices at issue? Given the combination of lapse and litigation, shouldn't flexible premium policy owners obtain a dispute defensible policy evaluation mindful of the policy's long-term planning purpose?

If you read, speak and understand life insurance, you're among a short list of informed policy owners, sales agents, third-party life insurance administrators, producer groups, brokerage general agents, life insurance organizations and legal, tax and investment advisors. However, if you don't read, speak or understand life insurance, you need an interpreter and intervention, and intervention should take a dispute defensible[1] form to maximize the probability of a favorable life insurance planning outcome for everyone involved.

Disclaimers

Most sales agents[2] and purchasers either don't read policy illustrations and policy contracts, or they don't understand what they've read. For example, illustrations and policy contracts for flexible premium products (universal life (UL), variable universal life (VUL) and equity indexed universal life (EIUL)) disclaim the use of an illustration for predictive value and policy comparison purposes. If the sales agent and purchaser read this disclaimer, why would they use carrier-generated illustrations or illustration-based methodologies for a known inappropriate purpose? Why would third-party life insurance policy administration vendors rely on illustrations for performance reviews? Why would brokerage general agents and sales agents use illustrations for policy replacement analysis and recommendation purposes? The agent's continued use of carrier illustrations for known inappropriate purposes begs the obvious allegations of questionable, misleading and deceptive marketing practices.

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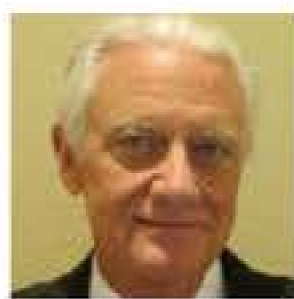

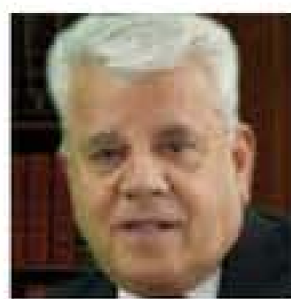

Lapsing Policies

In December 1980, the prime interest rate reached its all-time record high at 21.50 percent. "Buy term and invest the difference" threatened the sale and retention of traditional fixed premium guaranteed death benefit products. Using the concept of "buy term and invest the difference," flexible premium non-guaranteed death benefit products were introduced in 1982[3] and quickly became the product of choice for sales agents to market and for issuing carriers to grow their individual life insurance policy businesses.

This was a time of revolutionary, not evolutionary, change. The paradigm-shifting introduction of flexible premium, investment-linked and non-guaranteed death benefit products was ideally suited for the more sophisticated business and family office market segments. However, the industry predicted the creative destruction of the traditional transaction-driven retail agent distribution channel unless changes were made to compensation as well as to product-specific sales and service practices. These changes weren't made.

While the design of this product type received immediate acceptance, agent product knowledge, policy owner performance risk assumption, carrier illustration purpose, policy administration and management services and access to creditable policy risk management tools remain questionable, even 35 years later. Responsibility for "invest the difference" and the requisite risk identification and management form it should take remain as problematic today as they were 35 years ago for reasons that make no sense.

> Legal, tax, investment and life insurance advisor collaboration usually are essential to maximizing the probability of a successful planning outcome that successfully meets the client's best interests.

For example, issuing carriers illustrated the new UL product with a 12 percent to 16 percent annual policy crediting assumption to contract maturity, depending on the issuing carrier. Carriers knew that these double-digit interest rates weren't sustainable over a 10 to 50 year planning horizon.

Not surprising, the prime rate slowly declined from its record high to 12 percent in mid-1984, to 4 percent in 2010 and, currently, to 3 percent. Life insurance policy crediting rates are declared annually, and these crediting rates tracked this decline in the prime interest rate and other short-term yields.

Owner's/Trustee's Responsibility

The issuing carrier doesn't automatically adjust the policy's annually scheduled premium payment amount based on policy crediting rate and COI changes. In a declining interest rate market, the policy owner must increase the originally calculated premium to sustain the policy to its original maturity. The policy owner solely is responsible for communicating with the issuing carrier and requesting this calculation adjustment. If the adjustment isn't requested and the scheduled premium isn't subsequently increased, then the coverage duration period will be shortened. Unfortunately, few policy owners understand this responsibility and how to undertake it. Most owners mistakenly rely on the sales agent and/or the issuing carrier to communicate and coordinate this adjustment.

When VUL was introduced and sales agents were delivering clients carrier illustrations with a 12 percent constant rate of return crediting rate assumption regardless of asset allocation, they knew that this rate wasn't sustainable. As a result, the marketing of these products was frequently described as either "actuarial liar's poker" or "win the illustration beauty contest."

Fast forward to today. Even illustrations of the most recent "product du jour," EIUL, assumed 14 percent to 16 percent market returns prior to the 2015 National Association of Insurance Commissioners Actuarial Guideline 49 regulations (better known as "AG 49"). However, application of AG 49 calculates a

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10.87 percent 2016 equivalent S&P 500 total return while charging policy owners 25 percent to 50 percent higher costs than other UL-based product types to cover the added cost of the policy's index allocation options. As a result, even more policy owner problems can be expected if the economic outlook for a 6 percent to 8 percent average S&P 500 return (without dividends) for the next 10 years is correct.

For reasons that make no sense and invite disputes and litigation, the dismissive rationale for inappropriate use of carrier illustrations and for resultant policy lapse often is, "that's just the way it is." Or, is it? We need a new era of thinking, and it must take a dispute defensible form that safeguards the interests and objectives of all parties!

Viewing intervention from a problem-solution perspective, is an alternative process-driven channel available to resolve these risk management and lapse issues? Yes. It was introduced in the early 1980s and engaged by corporations to implement corporate-owned life insurance, banks to implement bank-owned life insurance programs and subsequently affluent family groups for multi-generational wealth preservation, management and transfer purposes. It's accompanied by life insurance counseling and creditable risk management. A credible solution has been available for 30 years and can readily facilitate the problem-solving transition from the retail channel.

Returning to the awkward question and carrier illustration discussion, Monte Carlo simulation and actuarial evaluation have been available for over 15 years to provide for creditable policy design and risk management. Unfortunately, few sales agents, third-party administrators, brokerage general agents or life insurance organizations (the traditional channel) use these tools due to either outdated frozen-in-time practices or a lack of awareness.[4]

Three Components of New Era

A new era of thinking is needed to: understand and speak life insurance; avoid lapse and litigation; and maximize the planning value of life insurance to the policy owner and policy beneficiaries. This new era has three basic components:

1. Informed intervention to obtain creditable carrier and product-type suitability evaluation, along with dispute defensible annual policy performance and post-sales risk management evaluation services based on policy objectives at the time of policy purchase.

2. Informed establishment of a current life insurance policy statement that sets out planning and policy objectives and effectively serves as a roadmap to reinforce the practices necessary to reasonably achieve the grantor's original planning purpose.

3. Informed advisor collaboration: Legal, tax, investment and life insurance advisor collaboration usually are essential to maximizing the probability of a successful planning outcome that meets the client's best interests.[5]

Endnotes

1. "Dispute defensible" refers to a process based on known: policy owner suitability criteria, fiduciary practices, life insurance agent licensing requirements, life insurance carrier contracting terms, policy contract terms, policy illustration disclosures and life insurance industry organization's best practices member guidance. "Dispute defensible" is an easy-to-understand term that unfortunately, like many other terms, has been co-opted by life insurance marketers, often for commission-motivated purposes. Our use of this term is litigation-based.
2. A life insurance sales agent is held to a suitability standard and, as such, is expected to know the purpose of an illustration and to communicate that purpose to the prospective policy owner. Because the carrier illustration doesn't serve a predictive value or policy comparison purpose, the agent should consider referral of a third-party policy risk management provider as part of a suitability letter to avoid allegations of misleading marketing practices in the event of policy under-performance and lapse.
3. E.F. Hutton Life Insurance.
4. Lack of awareness is doubtful. Illustration abuse has been a topical discussion since 1990 within the life insurance industry. In addition to a flexible premium policy illustration and policy contract, the Financial Industry Regulatory Authority, the Society of Actuaries, state insurance departments, continuing education providers, life insurance industry associations and respected commentators provide excellent guidance concerning the inappropriate use of illustrations for predictive value and policy comparison purposes. Further, creditable policy evaluation tools have been available for approximately 15 years and, as an example, are available to Society of Financial Service Professionals members.
5. These and other important details, forms and strategies are set out in our upcoming book, *The Life Insurance Policy Crisis—The Advisors and Trustees Guide to Managing Risk and Avoiding a Client Crisis*, which is available on the American Bar Association website, *http://shop.americanbar.org/ebus/store/productdetails.aspx?productid=255001766*.

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