EVALUATING SAVINGS-ORIENTED LIFE INSURANCE

With increasing concern over stock market performance and the impact of tax-deferred saving, more Americans are turning to cash value life insurance as a way to supplement their income in retirement. The two most common vehicles – Dividend-Paying Whole Life (WL) and Indexed Universal Life (IUL)[1] – both have strong advocates (and strong detractors) in the insurance and finance industry.

Many advisors are left wondering: Which product is a better choice for my clients?

While the appropriateness of any life insurance policy depends on factors personal to a given client, there are some broad features on which we can evaluate WL and IUL – features that greatly impact clients using these products as savings vehicles.[2]

PRODUCT GENESIS AND MECHANICS

Whole Life has been a mainstay of the insurance industry for nearly 100 years, with it's popularity waxing and waning depending on national mood and opportunities in the market. Whole Life products work like this:

- A policyholder pays the insurance company a premium to initiate the policy.
- This annual premium is set to support a given death benefit under two assumptions: the maximum mortality and expense charges, and the minimum interest rate the company estimates it would credit in a "worst case scenario."
- Over the course of the year, the insurance company's actuaries determine actual experience and make adjustments to the initial premiums through the declaration of annual dividends.
    - It is similar in concept to over-withholding for taxes every year and then getting a refund once your actual tax bill is known. Through dividends, policy holders are getting credit for the amount of premium overpayment initially charged.
- The cash value of the policy grows by these dividend interest credits.

Whole Life was the primary cash value life insurance used in the U.S. for many years. Then, in the early 1980s, consumers began to demand several updates to the basic life insurance structure:

- Increased transparency
- Better separation of the pure death benefit component from the savings element
- Enhanced flexibility

Universal Life was developed in response to these consumer demands. Advocates of the this new form of life insurance worked to modernize the traditional dividend-paying whole life structure. To meet continued consumer demand, in the late 1990s an indexed version of Universal Life was developed to expand consumer choice for policy interest credits.

Indexed Universal Life products work like this:

- An annual premium is set to support a given death benefit. In many cases, IUL policies are "overfunded," meaning the annual premium is more than required to carry the death benefit. This allows additional cash value to accumulate in the policy.

- Interest credits are determined based on a defined formula tied to an outside index (for example, the S&P 500® Index[3]).

- Annual expense and mortality charges are established and charged each year.

- The policy states maximum expense and mortality charges and minimum credited interest rates, as required by regulation. Unlike Whole Life policies, which assume these maximum and minimum rates in the premium calculation, an IUL policy does not charge these rates up front and then credit any difference. In IUL, these maximum and minimum rates serve as notice of what the insurance company could potentially use if future experience warrants adjustments.

PRODUCT EVALUATION

When evaluating Whole Life and IUL, it is important to consider five factors which have the greatest ability to impact consumer experience and value: Rating, transparency, the balance between cash value and death benefit, interest crediting, and maximum charges.

Let's look at each factor, and how it impacts each product's use as a savings vehicle.

#1. Financial Ratings of the Carrier

Any life insurance policy is, by its nature, a long-term financial instrument. Care should be taken to utilize sound, highly-rated insurers.

- Regardless of policy type, companies with an A. M. Best rating in the “A” category are preferable.
- Poorly-rated companies bring additional risk to your client – regardless of whether Whole Life or IUL is being used.

#2. Emphasis of Savings Component Versus Death Benefit Component

Today, a growing majority of Whole Life and IUL policyholders are using the policies for the twin needs of death benefit protection and cash value accumulation. That’s because cash value life insurance gives them the ability to accumulate funds tax-free, while also delivering a death benefit to their heirs.

While many savers want death benefit protection, they do not want to sacrifice cash value growth for more protection than they need. To aid in this determination, the IRS has established a set of rules that specify the minimum death benefit component that will allow an insurance policy to qualify for tax-free savings treatment.

If your client is using cash value life insurance as a savings vehicle, it’s important to balance these two needs correctly for your client. Both Whole Life and IUL can achieve this balance, *if* structured correctly.

- In Whole Life policies, when a dividend is declared, policyholders have a choice: the dividend can be used to increase the cash value, the dividend can be used to pay next year’s premium, or the dividend can be used to buy paid-up additions to the death benefit.
    - If a Whole Life policy is structured to use dividends for paid-up additions, the policy builds up a larger death benefit at the expense of the savings component.
    - If a Whole Life policy is structured to use dividends to pay next year’s premium, the cash value growth will suffer, as it no longer grows by both premiums and credited interest.

- If your client's goal is to maximize cash value growth – and this is often the priority for savers using cash value life insurance for supplemental retirement income – these Whole Life structures should be avoided.

- Conversely, many IUL policies are structured as "overfunded" policies, meaning more premium is paid than needed to support the death benefit. Additionally, IUL death benefits are often set at or near the IRS minimum.

    - This structure aims to maximize cash value growth while minimizing mortality charges, so more of the premium and interest credited remains in the account value.

#3: Interest Crediting

How interest is credited to the policy is perhaps the most important feature for your client. This is what distinguishes cash value life insurance from other products, and what makes it possible to use both Whole Life and IUL for supplemental retirement income.

The biggest difference between the two products is how interest is credited to the policy. In a Whole Life policy, credited interest is tied to internal carrier decisions. In an IUL policy, credited interest is tied to the movement of an external index.

Whole Life credits interest through dividends, or declared rates of return for a policy's cash value. Under Whole Life, the insurer's overall investment experience is embedded in the dividend scale.

- In years when experience is good, dividends are favorably impacted and may be higher.

- In years when results are not as good (for example, when interest rates are low or credit losses are high), dividends are negatively impacted and may be lower.

- Whether market experience is positive or poor, interest credited in a Whole Life policy is tied to internal carrier decisions; a client must wait for the company's dividend decision to know how much his or her policy has earned.

Perhaps the biggest innovation IUL introduced to the market place is the use of an outside index to credit interest to the policy. For example, the S&P 500® Index is often used, subject to an annual floor and cap.

Indexing gives policyholders the ability to indirectly participate in market gains, while being protected from market losses. It delivers a unique return pattern of growth and protection.

- When the market is up, policy holders participate in a meaningful portion of the market's growth, potentially up to a cap.
- Because most IUL policy indexes have 'floors' of zero, the credited rate can never be less than zero. The interest credited, then, is always zero or positive.
- Since there is a floor of zero interest credited, policy holders never give back past credits through negative credited interest.
- Because the index is reset every year, policy holders do not need to recover from the market's previous high in order to get future credits. This provides the opportunity for attractive crediting pattern, even when the stock market is volatile.
- IUL policy holders can determine how much interest will be credited to their policies by following the index or market. They do not need to wait on an insurance carrier decision.

The way interest is credited to Whole Life and IUL policies also impacts another key feature for your client: How the client can access funds from the policy through policy loans.

- In Whole Life policies, policyholders are limited in the types of loans they can choose. Additionally, its more difficult to analyze if a policyholder is earning a positive or negative spread on the loan, as the interest is imbedded in the dividend and not transparent.
- In IUL policies, policyholders have great choice in loan type, including the option for 'wash' or 'net-zero cost' loans. Policyholders have the flexibility to switch between loan types as needed. Finally, the interest spread on loans – if any – is transparent because it is tied to index performance.

#4. Transparency

Your client will want – and deserve – to know how interest is credited to his or her policy, and how expenses and mortality charges are deducted. Although no client is expected to understand every line of a policy illustration, clients should be able to readily see how the policy is being credited and debited.

This is a feature that varies widely between Whole Life and IUL, with IUL proving the far more transparent product.

- Under Whole Life, credits and charges are included in the dividend calculation and are not itemized separately.
- Under IUL, credits and charges are explicitly disclosed in the policy illustration.

Policyholders can obtain a more transparent accounting of interest credits, expenses and mortality charges in IUL.

This is critical distinction, as transparent expense loadings are how your client can determine if a policy's costs are attractive compared to cash value growth. Every client deserves to know if his or her policy is a good value for the benefits it delivers.

Under Whole Life, policy holders cannot determine expense charges independently, as they are included in the dividend scale and the premiums initially charged.

- This makes it more challenging in a Whole Life policy to understand the impact of the expenses being charged against the policy on the policy's growth.

Under IUL, expense charges are detailed in the illustration.

- This makes it possible to show not only exact annual expense charges, but, more importantly, how these expenses relate to the average cash value growth over long periods of time.
    - You and a client can evaluate how mortality and expense charges impact cash value growth – and answer the important question: Is this policy a good value?

#5. Maximum Expenses and Mortality Charges

Maximum expenses and mortality charges (the highest amounts a given insurance contract can legally charge) are an important part of policy structure, as they provide the "worst case scenario" a client may experience. As mentioned in the introduction, Whole Life and IUL treat these maximum charges very differently.

- A Whole Life policy establishes a premium large enough to accommodate the maximum mortality and expense charges; it assumes the worst, so to speak.

- The insurance company then adjusts downward via dividends based on favorable experience. In a sense, it rebates the portion of the maximum charges that were not actually assigned to the account.

In an IUL policy, the premium is not set based on an assumption of maximum charges. Instead, a set of current charges are assumed, which are below the maximum but not guaranteed to be the actual charges the policy will experience in the future.

- This allows more of the premium to go toward cash value growth, as policies are not charged the maximum rate.

- Under normal circumstances, IUL maximum rates are not applied: they are there to protect the solvency of the insurer and their policyholders if future experience does not prove as favorable as expected.

In essence, both IUL and Whole Life companies have built flexibility into their products if future markets are less favorable than assumed:

- In Whole Life, the dividend is not guaranteed, so the company can choose to keep more of the maximum mortality and expense charges.

- In IUL, the current expense and mortality charges are not guaranteed, so the company can choose to raise fees if needed in the future.

SUMMARY

Overall, IUL and Whole Life use different approaches to delivering value to their policyholders.

IUL brings value through transparency, indexed crediting, and direct accounting of costs in the policy. Whole Life brings value through annual dividends.

Your client is choosing cash value life insurance to meet the dual needs of death benefit protection and cash value growth. Each product offers a different emphasis between the two:

- In general, the Whole Life policies we see tend to generate higher death benefits at the expense of savings growth, while the IUL policies we see tend to favor cash value growth while keeping death benefits closer to the IRS minimums.

As with any insurance or financial product, the needs of the client will ultimately determine which approach is best.

About the Author

Martin Ruby, FSA, is an author, actuary and CEO of Stonewood Financial. Martin has decades of experience developing, pricing and selling insurance products. He drove the creation of one of the very first Universal Life products, and is one of the industry's leading experts on Indexed Universal Life insurance. Previously, Martin served as CEO of Integrity Life Insurance Companies and was a senior executive at Capital Holding Corporation (now part of AEGON).

Disclosure and Footnotes

This paper is for advisor use only and is not for use with clients. This paper is not intended to provide tax, legal or investment advice.

[1]This paper is not intended to provide a complete overview of all product features and benefits of any particular life insurance product. Life insurance policies are contracts between the client and issuing insurance carrier. Life insurance guarantees rely on the fiscal strength and claims-paying ability of the issuing insurer. Universal Life and Whole Life products are not bank or FDIC insured. Indexed Universal Life products are not an investment in the stock market and are subject to all policy fees and charges associated with Universal Life policies. Life insurance products contain terms, conditions and restrictions that vary by insurance company and by policy. There are suitability considerations for both Indexed Universal Life and Whole Life products. Please refer to a specific carrier product illustration for complete information on benefits, costs, features and riders available to policy holders.

[2]The primary purpose of life insurance is to provide a death benefit. Life insurance is just one component of a client's overall financial and legacy strategy.

[3]The S&P 500® Index is a product of S&P Dow Jones Indices LLC or its affiliates.