**Universal Life Insurance in a Low Rate Environment**

**By: Daniel M. Haut, CFP®, CIMA®**

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A few years ago, a new client asked me to review a "universal" life insurance policy that she bought in the early 1990's. The insurance company had recently increased her annual premiums by a whopping 32% and the policy would soon lapse unless she opened up her wallet. Suffice it to say, she was equally surprised and perturbed. The broker sold her on the "flexibility" of the premium payments with universal life; flexibility that doesn't exist with term or whole life policies. Unfortunately, her broker conveniently forgot to mention that the flexibility of "universal" policies can also come with steep costs.

My client's dilemma is not unique and is ubiquitous among carriers who sell universal life insurance. In fact, as recently as 2015, insurance carriers like Voya, John Hancock, and Transamerica faced lawsuits for increasing annual premiums in universal life insurance policies by double and even triple digits.[1] While some of the lawsuits were successful, many more were not. If you read the fine print (which most consumers do not), insurance companies are contractually allowed to adjust insurance costs up to a maximum cap rate. Oftentimes, this premium cap is much steeper than when initially underwritten.

The two questions you're probably asking yourself are: Why did these insurance companies - out of the blue - raise their premiums by such a hefty percentage? How can I make sure that this doesn't happen to me? Before I delve into both questions, it is first important to cover both how insurance is generally priced and which factors make universal policies especially unique.

**Cost of Life Insurance**

Per the American Academy of Actuaries in Washington DC, there are a number of factors that go into the cost of all life insurance. Some of the factors include: projected investment returns, mortality expectations, anticipated operating costs, policy lapse rates, and taxes.

The cost analysis for "permanent" policies is much more complicated than for term policies. Permanent insurance (e.g. whole life, universal, variable) is different from term insurance in that not only does it not expire, but it provides a "cash value" to the owner.

Unlike with term insurance, for cash value policies, when one pays a premium, the payment is allocated into three buckets. The first bucket is the cost of insurance or death benefit (based on age, health, and morbidity risk of the insured). The second bucket pays for the insurance company's operating costs, administration, and profits. The third bucket will go toward the policy's cash value, which is generally invested in a conservative portfolio of long-term government bonds.

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The cost of life insurance is directly linked to the age of the insured. Therefore, with permanent policies, younger owners allocate a greater percentage of their premium towards building up a cash value because the cost of insurance is small in the earlier years. As the policy owner ages, the opposite happens. A relatively larger allocation of the premium payment goes towards the cost of the insurance relative to the cash value. At that point, however, the cash value has already been accruing for a while and is often sizable.

**Cash Value Accrual**

While permanent policies are different than term policies, there are unique differences between the various types of permanent policies. These differences are especially true in terms of how their cash value grows. For instance, whole life policies provide "guaranteed" cash value accounts that grow at a specified and formulaic rate. Variable life policies place the cash value into investment "sub account" funds that perform relative to the portfolio's asset allocation. Universal policies, however, grow their funds based on the current interest rate environment.

In a rising interest rate environment (e.g. early 1980's and 1990's), it can be great to own a universal policy. After all, the cash value accrual is commensurate with rising yields. As bonds owned by the insurance company mature, the proceeds are refinanced into even higher yielding bonds which is great for the policy owner. Further, the "flexibility" of owning a universal policy - euphemistically speaking - allows the owner to pay premiums whenever they want, unlike with term or whole life policies.

When the owner of a universal policy has a large cash value during a period of rising rates, they have quite a bit of flexibility. For one, they can take out a loan against the cash value (e.g. college, home renovation, etc.). If they opt to not pay back the loan, it is simply deducted from the face value or death benefit. Second, they can supplement their retirement income by using the cash value as an annuity. Third - and the most popular option - they can fund future premium payments with the built up cash value. It is not uncommon for owners of universal life insurance to eventually forego premium payments altogether, with the expectation that the cash value balance will continue to foot the bill into perpetuity.

Unfortunately, the flexibility offered by universal policies would help create the perfect storm in 2008, as the global economy suffered the greatest recession in nearly 80 years.

**Housing Crisis Leads, Low Interest Rates, and Rising Premiums**

At the end of 2008, Lehman Brothers, Bear Sterns, and Country Wide had all collapsed. Fannie Mae and Freddie Mac were on life support. The auto industry (Ford, GM) were on the ropes and reeling. With the economy in free fall, the Federal Reserve - led by Ben Bernanke - lowered the Federal Funds rate to 0.25% on

December 17, 2008, which was the 10th cut that year. In fact, from December 2008 until December 2015, the Federal Reserve's monetary policy kept interest rates at effectively 0% in order to stimulate an ailing economy.[2]

As interest rates sunk to record lows post housing crisis, life insurance companies were hamstrung with bond portfolios providing historically low coupons. To add insult to injury, unrealistic actuarial projections forced many insurance companies to continue to credit cash values according to previously high guaranteed rates. With interest rates bottoming, and insurers unable to match the duration of their assets with their liabilities, they were forced to increase their premiums in order to drive a profit.[3]

In the meantime, many owners of universal policies had eroded their cash values for years in order to fund the future premiums. With dwindling cash values and premiums that doubled and tripled due to the artificially low interest rate environment, universal policies began to lapse at record rates.

**The Value of Regular Inforce Illustrations**

So should consumers avoid universal life insurance all together? The answer is no. To be clear, the intention of this article is not to denigrate the appeal or use of universal policies in an absolute sense.

For one, "guaranteed universal," or "second to die" policies are often the most cost effective type of policy to use for estate planning purposes. If interest rates steadily rise, it *may* be a good time to consider universal life insurance assuming one is aware of the risks. There are many ways to prevent the lapse of a universal policy, which exclude paying the much higher premium.

How does one prevent the lapse and avoid paying a higher premium? The answer is to take a proactive approach. Changes to interest rates, inflation, tax rates, and life expectancy all suggest that a financial planner review your life insurance policy once every three years. An inforce illustration - which can be ordered directly from the insurance company provided to your financial adviser - is the most fundamental tool to review your life insurance policy.

The inforce illustration will first and foremost provide transparency about the basic nuts and bolts of your policy. According to one survey funded by Lend EDU, while 54% of Americans own life insurance, 33% indicated that they do not understand the mechanics of their policy.[4]

An inforce illustration will also identify several inflection points that may pose problems for universal policies. These inflection points include but are not limited to: lower actuarial interest rate crediting than initially assumed, lower than anticipated portfolio performance, increases in cost of insurance, excessive withdrawals, existence of policy loans, unpaid premiums, low internal rates of return, and increased premium rates.

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Last, and most importantly, an inforce illustration can provide the financial planner with the answers needed to prevent the lapse of your policy. Some of these options may be to: reduce the face amount, convert to a guaranteed paid up policy (lower death benefit), 1035 tax-free exchange, swap for a life-settlement option, or donate the policy for a charitable deduction.5 Had my new client been proactive with her insurance policy over the years and requested an inforce illustration, she may have been able to take steps to mitigate the shock she received when I reviewed the policy. So if you too have a universal life policy, heed this client's experience and discuss an inforce illustration with your advisor today.

[1] Ryan Neal, "Transamerica pays $195 million to settle lawsuit over universal life insurance" investmentnews.com, 4 October 2018, https://www.investmentnews.com/article/20181004/FREE/181009958/transamerica-pays-195-million-to-settle-lawsuit-over-universal-life

[2] Michael Bauer, Glenn Rudebusch, "Why are long-term interest rates so low?" frbsf.org, 5 December 2016, https://www.frbsf.org/economic-research/publications/economic-letter/2016/december/why-are-long-term-interest-rates-so-low/

[3] Report Linker, "How has the insurance industry dealt with low interest rates?" June 2018

[4] Mike Brown, "54% of Americans own a life insurance policy, but one-third not exactly sure how it works" lendedu.com, 28 August 2018, https://lendedu.com/blog/life-insurance-survey/

[5] John Kador, "Surrender a universal life insurance policy?" wealthmanagement.com, 31 May 2017, https://www.wealthmanagement.com/insurance/surrender-universal-life-insurance-policy

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