Chapter 1

Introduction

In the late 1970s and early 1980s, a far-reaching and profound paradigm shift occurred within the life insurance industry that drastically affected how life insurance is perceived, managed, and evaluated. Yet this paradigm shift and its potentially adverse policy owner implications went almost completely unnoticed and resulted in and precipitated the life insurance policy crisis that exists today. The great divide, cross over point, and risk transfer to the policy owner occurred in 1979 with the introduction of life insurance policies where the pricing of the life insurance product was no longer based upon long-term guarantees and fixed schedules of premiums but was based on current non-guaranteed assumptions and flexible premium payments—the essence of what is referred to now as the family of universal life products.

This is not to say that this paradigm shift was necessarily a bad thing. Quite the contrary. All paradigm shifts have good and bad, and positive and negative aspects. However, change to a new paradigm requires adaptation and, quite frequently, a new support system. The problem with the life insurance paradigm shift that occurred was the almost complete lack of adaptation to the risk transfer precipitated by current assumption non-guaranteed flexible premium products, and the corresponding non-developed risk management and evaluation practices and support systems necessitated by the new paradigm.


2. Noted visionary, celebrated actuary, and former president of Tillinghast, James C.H. Anderson, was one of the pioneers who conceived and developed variable and universal life insurance products in the 1970s and early 1980s. Mr. Anderson strongly felt that universal life insurance was a consumer-oriented product that required the complete revamping of the traditional distribution system of life insurance carriers to make it cost competitive and in-line with other savings institutions. He envisioned that the “original agency organization will be disbanded and replaced by a new service-oriented organization designed to maintain its established customer relationships.” [The Papers of James C.H. Anderson, Actuarial Education and Research Fund, Schaumburg, Illinois, 1997, “The Universal Life Insurance Policy,” page 217.]

Unfortunately, in reviewing universal life insurance ten years later in 1989, Anderson noted: Distribution Costs. Beginning around 1983, new versions of Universal Life began to emerge. These products featured a return to traditional commission rates coupled with “concealed loads” of various types. This change represented a return by the life insurance industry to its traditional
The new product was touted as being “transparent” and described as, in effect, the equivalent of “buy term and invest the difference,” with the difference being invested internally within the policy. Policy owners were never told how to prudently risk manage the performance of the policy, especially the changing premium payment risk to prevent policy lapse. Pricing that is based on a “current” non-guaranteed crediting rate and cost of insurance assumptions has required increased premium payments. Unfortunately, most policy owners as well as many sales agents were neither aware of these changes and the requirement to monitor these changes, nor how to obtain correcting premium information to avoid policy lapse.

As already noted, sales agents had minimal familiarity with how the non-guaranteed features of this new product could interact to adversely affect policy performance. Additionally, questionable marketing practices with these non-guaranteed flexible premium product types over the past 35-plus years has adversely impacted how life insurance is perceived, sold, administered, and risk managed. Ironically, because of the dramatic changes brought about by this distribution-based philosophy and a rejection of the consumer-based philosophy which Universal Life was intended to promote.


However, in that same 1989 commentary Anderson observed in a section titled “What Next?: “Distribution. It may not be possible to distribute an unbundled product in the conventional, high-cost way. Universal Life may become the product of nonconventional distributors, while others offer it only as the product of last resort.” The Papers of James C.H. Anderson, Actuarial Education and Research Fund, Schaumburg, Illinois, 1997, “1989/1 Universal Life 10 Years Later,” page 619.

By the way, in that same section, Anderson fully acknowledges the risk paradigm shift of variable universal life insurance:

Investments. The cash management problems of a product without fixed premiums are inherently different from those of traditional products. When the next interest rate spike occurs, consumers demand for new money investment returns on in-force Universal Life policies may give rise to significant new financial problems for the insurers. Variable Universal Life effectively addresses this problem by passing the investment risk back to the policyholder.


3. Whitelaw and Montag, supra, note 1, page xiv.
4. Ibid, pages xiv, 5, and 11. Whitelaw and Montag also note:

[T]he scheduled policy owner premium payment amount is not adjusted annually, based upon crediting rate and cost of insurance changes. In a declining interest market, the originally calculated and scheduled premium must be increased to sustain the policy to its original maturity. The policy owner solely is responsible to communicate with the issuing carrier and request this adjustment. If the adjustment is not requested, and the scheduled premium is not subsequently increased, the duration of coverage will be shortened. Unfortunately, few policy owners understand this responsibility and how to undertake it. Most owners mistakenly rely upon the sales agent to communicate and coordinate this adjustment.

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The economic conditions of the early 1980s were a perfect incubator for the universal life variation of whole life. The economy was experiencing extremely high inflation rates and very high nominal rates of investment return. The real rate of return, however (nominal rate of return minus inflation rate), was quite low. Inflationary expectations were so rampant that investors were avoiding long-term investments, and the demand for short-term investments was outstripping the supply of funds, leading to what is known as a reverse yield curve (the cost of borrowing short-term funds is actually higher than the cost of borrowing for long-term mortgages). During more normal economic conditions, higher rates for borrowing are associated with longer-term investments, and lower rates are associated with the shortest investment durations.

6. In 1942, Austrian economist Joseph Schumpeter in *Capitalism, Socialism, and Democracy* used the term “creative destruction” to label the process of mutation that incessantly revolutionizes the economic structure from within, destroying the old one and creating a new one. Innovation creates obsolescence and replaces it. Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy*, Harper & Brothers, New York, New York, 1942.


8. “Dispute defensible” is a term coined and used by E. Randolph (Randy) Whitelaw, AEP® (Distinguished), the Managing Director of Trust Asset Consultants, LLC, to describe proper or best practices in the evaluation of life insurance and administration of the trust estate in the irrevocable life insurance trust (ILIT). Randy is a national expert and consultant in this subject matter and has served as an expert witness in litigation on these matters, including the watershed case *Cochran v. KeyBank*.

Both short-term investment returns and inflation were hovering near 20 percent annual rates. This prompted many policyowners with traditional life insurance contracts to pull the cash value out of their existing life insurance contracts via policy loans or policy surrenders and invest the funds directly in these new high-yield investments. This process is commonly referred to as disintermediation.

Life Insurance companies were looking for a way to stem this outflow of funds that was forcing many of them to liquidate some of their long-term investments at a loss in order to honor policyowner requests. In such an inflationary environment the traditional fixed dollar life insurance contract lost much of its appeal.

Stock insurance companies were the first ones to introduce universal life policies. . . . . The real advantage was that nearly every insurance company introducing a universal life policy did so through a brand-new company that invested all of its assets into a new money portfolio and earned very high short-term investment yields. These yields seemed astronomical when compared with the yields being earned by traditional life insurance companies with long-term investment portfolios. Although the tremendous immediate advantage of higher yields could not persist over the entire duration of the life insurance contract, it was successfully exploited in the marketplace for the few years it lasted. [Emphasis added by the author.] After normal investment conditions returned and yields dropped to lower levels, the universal life policies decreased in popularity. Insurers selling universal life insurance started investing in longer term assets to increase their returns, and the total portfolios associated with universal life policies became very similar to those of seasoned insurance companies with large blocks of traditional whole life policies in force.10

In the above quoted paragraphs, Professor Graves is referring to the first type of universal life policies. All of the original non-guaranteed flexible premium products had portfolios backing up the cash value reserves of the policy consisting of mostly fixed income securities that are part of what is referred to as the general asset account of the insurer. Subsequent variations of the universal life product—such as variable universal life and indexed universal life—further exacerbated the risks associated with non-guaranteed flexible premium products.

In order to develop a thorough understanding of the nature of the risk-transfer paradigm shift problem, Chapter 2 will first examine the basic pricing elements of life insurance—mortality costs (rates), operation expenses, and interest (or earnings)—and the interaction between these pricing elements that, all too often, tends to be ignored. This chapter will include a discussion of the concepts behind mortality tables that are the basis of all life insurance policies. The simplest application of mortality tables to life insurance products is to term life insurance. Hence, this product will be examined and discussed, including the limitations of term insurance

that led to the development of permanent or whole life insurance that will also be examined and discussed.

In the general examination—and evolution—of permanent life insurance products, this book will explore the purely guaranteed whole life product design in addition to the non-guaranteed design elements of universal life-type products. The effect of assuming a constant rate of interest on non-guaranteed policy cash value reserves—or the earnings on policy sub-accounts in variable universal life-type products—used in life insurance policy illustrations are graphically compared and analyzed to rates of returns that vary but average the same overall return as the constant assumption used in the policy illustrations, and all too often used to determine the funding premium level of universal life products. The effect of the results of the difference from assuming a constant rate of return versus the more realistic varying rates of return on the interplay between the pricing elements of the life insurance policy will be graphically demonstrated and explained.

Risks inherent with life insurance will be considered and explained in Chapter 3, including the risks associated with some of the more common product types such as:

- Purchasing power risks, which are all too often ignored with the emphasis on minimum premium types of product.
- Product suitability that will explore the changing needs for life insurance over the life of a policy, product type appropriateness based on risk tolerance and the preference for either the lowest possible premium or growth in the death benefit and cash values of the policy, and the effect of changing premium paying capacity. Part of the product suitability discussion will consider the need for policy replacement and/or the option of a life settlement.
- Since life insurance by itself is a concentrated asset, the need for diversification by either multiple life insurance carriers or by different product types, or both, will be considered.

Risk management requires a process and life insurance is no exception. Hence, in Chapter 4, the process of managing life insurance policies will be discussed, particularly noting the need for a life insurance policy management or investment policy statement. Part of the management process will explore the value and need to use personalized life expectancy report assessments.

Chapter 5 of this book will analyze the creditable evaluation of life insurance, particularly non-guaranteed flexible premium life insurance policies. In 1992, a Society of Actuaries task force on policy illustrations presented their findings and report on the use of policy illustrations with non-guaranteed elements and values.11 Similarly, the Financial Industry Regulatory Authority (FINRA) promulgated

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FINRA Rule 2210, part of which dealt with the use of hypothetical policy illustrations in variable life products to project or predict values, or to compare products.\textsuperscript{12} Both the Society of Actuaries and FINRA rule made it clear that policy illustrations could not be used to project or predict, or compare, non-guaranteed policy values. Despite these authoritative pronouncements against the use of policy illustrations to project or predict non-guaranteed policy values, or to compare one life insurance policy to another, too many financial planners and life insurance professionals are ignoring these directives and are improperly using policy illustrations to evaluate non-guaranteed life insurance.\textsuperscript{13} After describing what are not acceptable methods of evaluation for non-guaranteed life insurance products, we will explore the criteria that is required and the methods for acceptable evaluation of non-guaranteed life insurance products. Finally, we will present the application of a method that meets such criteria to a real-life example to demonstrate the creditable evaluation of non-guaranteed flexible premium products.

Last before the conclusion in Chapter 7, but certainly not least, Chapter 6 will discuss and provide practical questions and guidelines to acquiring and managing life insurance in order to avoid a client crisis. Life insurance needs to be properly acquired and managed through a process. The practical questions and guidelines in Chapter 6 are designed to assist policy owners in developing a thoughtful life insurance program by implementing prudent systematic procedures for purchasing and managing their life insurance policy or policy portfolio, to maximize the probability of successful long-term outcomes tailored to their individual unique goals, needs, and objectives.

Additionally, to give diverse insights that either reinforce, expand, or provide different perspectives than those composed by the author, the end of the book contains a section of Contributed Articles from nationally known practitioners and advisers from the legal, actuarial, financial, and trust fields with extraordinary expertise in life insurance. These articles from notable, knowledgeable authors illustrate and offer unique viewpoints and thoughts on the topics covered. They truly expand the concepts and ideas of “Explaining the Unexplainable.”

\textsuperscript{12} FINRA Rule 2210—IM-2210-2, Communications with the Public about Variable Life Insurance.
\textsuperscript{13} Whitelaw and Montag, \textit{supra}, note 1, page 4 and footnote 8 on page 4.