Damage Control

The market slide has zapped VUL policies, but you can help clients avoid disaster

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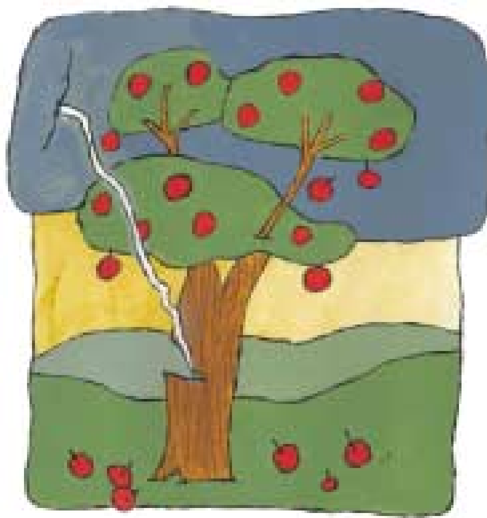

DURING THE LATE 1990S INsurance agents had an easy time selling variable universal life (VUL) policies, which let investors participate in the stock market's performance. Many agents would shower prospects with sales illustrations showing how much money the policies would amass if the underlying investments returned 12 percent per year—often apologizing that the National Association of Securities Dealers (NASD) wouldn't let them use even-higher return projections.

You know what happened next. After two years of negative returns, most of these variable universal life policies are falling far short of the earlier rosy projections—even the worst-case scenarios included on the sales illustrations called for a 0 percent return. Many policyholders had no idea how devastating a year or two of negative returns could be for their policies.

The end result: Not only are cash values down—which of course presents problems if policyholders expected to use the money for retirement income, college costs, or other expenses—the policies themselves may also be in jeopardy. Some people have already received notices from their insurance company warning that their policies will lapse unless thousands of dollars are injected into them within 60 days. Others have yet to realize that their policies are being eaten away as their dwindling cash values become too small to support annual insurance fees. These policyholders have no idea they're on track to receive lapse notices in the next few years. "Very few companies are sending out advance warnings that individuals should be monitoring their policies closely," says Bob Littell, principal of Littell Consulting Services in Atlanta, which specializes in life insurance.

The problems arise from the way costs are assessed within the policy. Part of each premium payment goes toward insurance costs, administrative fees, mortality charges, and other ongoing expenses. The rest goes toward the cash value, an investment account that grows tax-deferred and that policyholders can borrow against. The cash value is then invested in mutual fund–like subaccounts. Policyholders can usually choose from more than a dozen equity funds, a few bond funds, and a fund with a guaranteed fixed return. The cash value fluctuates with the performance of the investments. But what some policyholders don't realize is that when the subaccounts lose money, the cost of the policy can be affected.

That's because insurance charges are based on the "net amount at risk," or the difference between the death benefit and the cash, or investment account, value. If a client has $1 million death benefit and $400,000 in cash value, for example, she will be charged based on the $600,000 net amount at risk. But if the policy's cash value drops to $300,000, the client will be charged based on the the higher $700,000 net amount at risk. Meanwhile, insurance costs within the policy increase as the policyholder gets older, just as they do with term insurance.

Individuals who tried to pay the lowest premium possible for their policies are often the worst off when the markets take a dive because they're the ones with the relatively smallest cash

Illustrations by Esther Pearl Watson

values. Variable universal life policies have built-in flexibility—investors can vary the frequency and amount of premium payments—within limits. But this flexibility often causes confusion for policyholders, who have difficulty understanding that paying higher premiums doesn't necessarily mean the policy is more expensive; it's just that they're sending more money to the cash value and providing a bigger cushion to cover any cost increases. "Cases in which someone said, 'I can sell you the same policy for 30 percent to 40 percent less than what you're paying'—those are the ones that are in real danger," says Littell.

The problem is magnified for a client who's been borrowing money from his policy for income. Policy loans aren't taxed as long as the policy is in force. But if the holder drops the policy before death, he'll owe income taxes on the difference between the amount paid in premiums and the amount withdrawn. This can add up to a hefty tax bill if the policyholder has been taking policy loans for years, even if the money is long gone. "People who are using their VUL policies as a source of tax-free income in retirement through policy loans need to be especially vigilant, because they can find themselves caught in what [insurance expert] Joseph Belth calls the 'surrender squeeze'—when a policy is too expensive to keep and too expensive to drop," says Glenn Daily, a fee-only insurance consultant in New York.

So what can you do to help clients guard against danger? For starters, if any of your clients have variable universal life insurance policies—particularly if they bought them years before they started working with you—you must help them obtain an updated inforce illustration, which shows the projected cash value based on the policy's current values and whatever investment returns you want to assume. The

Clients can use a loss to their benefit if they make a tax-free 1035 exchange into an annuity

illustration will help determine whether the policy is destined to lapse much earlier than expected.

If this is the case, there are a few ways to fix the situation: increasing the annual premiums, making a lump-sum payment, lowering the death benefit, or dropping the policy altogether. Before helping a client decide what to do, Thomas Endersbe, a senior financial adviser at American Express Financial Advisors in Eagan, Minn., suggests testing several variations. “Run a couple of scenarios—less premium, more premium, varied death benefit, and varied rate of return,” he says. “Then you can see the impact of these actions to see the pressure points that can drive the policy to good health or cause it to be at risk.”

For example, if a healthy 45-year-old man bought a $500,000 variable universal life policy in 1997 and paid $2,950 per year in premiums, he’d receive an initial illustration showing that the policy would remain in force until he turns 100 and the cash value would be $11,472 in 2002, assuming 12 percent annual returns. But his investments probably ended up performing much worse than that during the past couple of years. If his cash value was half the original projection in 2002 and you assumed a more-conservative 8 percent return going forward, his policy would lapse when he turns 72, says Dick Weber, president of Ethical Edge Insurance Solutions in Carlsbad, Calif. To keep the policy in force until the client turns 100, under those assumptions, Weber says he’d either have to urge the client to increase his annual premium to $5,850 or make a lump-sum payment of $32,000 and continue to pay his $2,950 annual premiums.

Before instructing a client to throw more money into a policy, though, make sure you do a needs analysis. “It’s less about what’s happened to the subaccounts and the value,” says Bill Starnes, a partner with Mallard Advisors, a fee-only financial-planning firm in Newark, Del. “It’s more about ‘does the client even need the coverage?’ If he does, how will we make the most of it? And if he doesn’t, how are we going to lose as little as possible from what we’ve done?”

But it can be tough to get out of a VUL policy without losing more money. Most insurance companies assess surrender charges if the policy is dropped in the first 12 to 15 years. The charges, which gradually diminish over the life of the policy, are subtracted from the cash value when the client cashes out of the policy. “Surrender charges can be huge in larger policies,” says James Hunt, life insurance actuary with Consumer Federation of America in Concord, N.H., who has seen some last as long as 20 years. In October 2001 he analyzed the options for a 35-year-old woman who had a $2 million VUL policy. The cash value had dropped to $21,000 and the surrender charge was $28,000. The client couldn’t be charged a surrender fee higher than the cash value, but she would have ended up with nothing if she surrendered the policy. She decided to keep the policy until the surrender charge was significantly reduced. Of course, you don’t always have to wait until the surrender period ends entirely; in some cases the surrender charge will drop significantly after a few years, and it may become worthwhile to take the hit then rather than continue paying for the policy.

One move to consider while biding time until the surrender charge becomes manageable is to lower the death benefit and have the client stop paying premiums. Thomas Fritz, a partner with Wilson Financial Advisors in Salt Lake City, recently converted one client’s ailing VUL policy to a paid-up policy with a lower death benefit. “We made the best out of a bad situation and pulled the plug,” he says. He determined that the client only needed the insurance for another 30 years. Then he found out how far he’d have to lower the death benefit for the policy to stay in force for 30 years if the policyholder stopped paying premiums, assuming a conservative 6 percent return. If the client needed more coverage, he’d make up the difference with term insurance.

If the surrender charge is minor, clients can drop their policy entirely. They can’t write off a loss on their income taxes, but they can use the loss to their benefit if they make a tax-free 1035 exchange into an annuity. Their cost basis will still be the total premiums they had paid into the VUL policy—including both the investment and the insurance costs. So if they’ve paid in $100,000, but the cash value has dropped to $50,000, they can make a $50,000 exchange into an annuity and only owe taxes on earnings above $100,000. When making the transfer, stick with low-cost annuity sellers like TIAA-CREF and Vanguard, recommends Starnes, who adds that you should make sure the new company has

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the accurate cost basis—he's seen many errors in that area.

Here are some other moves you can make to help clients avoid future problems with their VUL policies.

■ **Look for a no-lapse guarantee** More companies are offering such guarantees, at least for the first few years of the policy, as long as you maintain a higher premium level. "I don't consider that to be an extra cost," says John Olsen, a principal at the Olsen Financial Group in St. Louis. "You should be doing that anyway."

New York Life Insurance Co., for example, automatically offers a three-year no-lapse guarantee on almost all its policies. You can request that the guarantee be extended to age 70, 80, or 100 for a higher premium. Most of the extra money goes toward the cash value—there's only a small administrative fee of a penny per month per $1,000 of death benefit ($30 per year on a $250,000 policy). A 40-year-old woman with a $250,000 policy, for example, would get the three-year no-lapse guarantee if she paid at least $846 in annual premiums. To extend the guarantee to age 70, she'd have to pay annual premiums of $1,677. But Daily says that the no-lapse guarantee is worthwhile only if it lasts long enough. "I can sometimes find a use for them if they continue for life, but I rarely have a use for them if they stop at age 100 or earlier," he says. If they do end earlier, the policy is still vulnerable when the insurance costs get the highest.

■ **Invest some money in a guaranteed account, rather than a riskier equity subaccount, and use the payout from the guaranteed account to cover the policy's expenses,** recommends Ben Baldwin, author of *The New Life Insurance Investment Advisor* (McGraw-Hill). "If your client does that—if you're sure there's enough money to cover the expenses—then the client can let his volatile funds be volatile and ignore them or rebalance them or whatever suits his current needs."

■ **Be particularly careful of fees** When investment returns are low, every little bit counts. "People have to remember they're probably losing about 2 percent for mortality charges and expenses," says Chuck Hinners, principal of Compensation Resource Group in Madison, Wis. "So if they have a gain of 2 percent from an investment standpoint, that's all taken back."

■ **Stay vigilant** "You can never put a VUL policy on autopilot," says Olsen. "You should review it every year. If the NASD would let us have a tool that allowed us to illustrate the impact of varying investment returns—and varying cost of insurance—we could get our clients to understand that the risks inherent in VUL are a lot bigger than they thought. The client would realize that when the agent is telling them to pay a big, fat premium, it isn't because the agent is greedy."

Even though the NASD has not approved them for use with clients, advisers can use certain software programs like the Historical Variability Module (available for $395 from Financial Profiles, a software firm in Carlsbad, Calif.) to see how a policy holds up under historical market conditions—and review the status every year. This Monte Carlo software runs the premium, cash value, and average insurance costs through hundreds of investment-return possibilities based on historical simulations and determines how likely it is the policy will last until the insured reaches age 100.

Let's return to Weber's example of the 45-year-old man who was paying $2,950 a year for $500,000 of insurance. The policy was projected to remain in force until the man reached age 100 as long as the investments returned exactly 12 percent per year. That won't happen in real life—some years returns are higher and some years they're lower, and the pattern of actual returns can make a big difference in policy performance. When Weber ran 1,000 hypothetical illustrations for a portfolio of 60 percent equities and 40 percent fixed income, for example, the $2,950 premium was high enough to sustain the policy until the policyholder turned 100 in only 6 percent of the scenarios. Using hypothetical illustrations for a 100 percent equity portfolio, the probability rose to 48.5 percent—but that still means the policy would lapse before the policyholder turned 100 in more than half of the scenarios. To raise the probability that the policy would be in force at age 100 to 80 percent, the policyholder would have to pay $3,750 per year from the start.

The bottom line: VUL policies demand a great deal of attention. "Understand that this is an investment in addition to insurance and, therefore, don't ignore it," says Starnes. "Advisers often ignore these things because they can't get them under their assets-under-management umbrella, or they just don't bother with them. But if you're looking at a person's total wealth, you also have to look at any VUL policy they have—its value and its investment potential."

If the policies lapse, your clients end up without the insurance or the investment—which will throw a wrench into their financial plans.

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