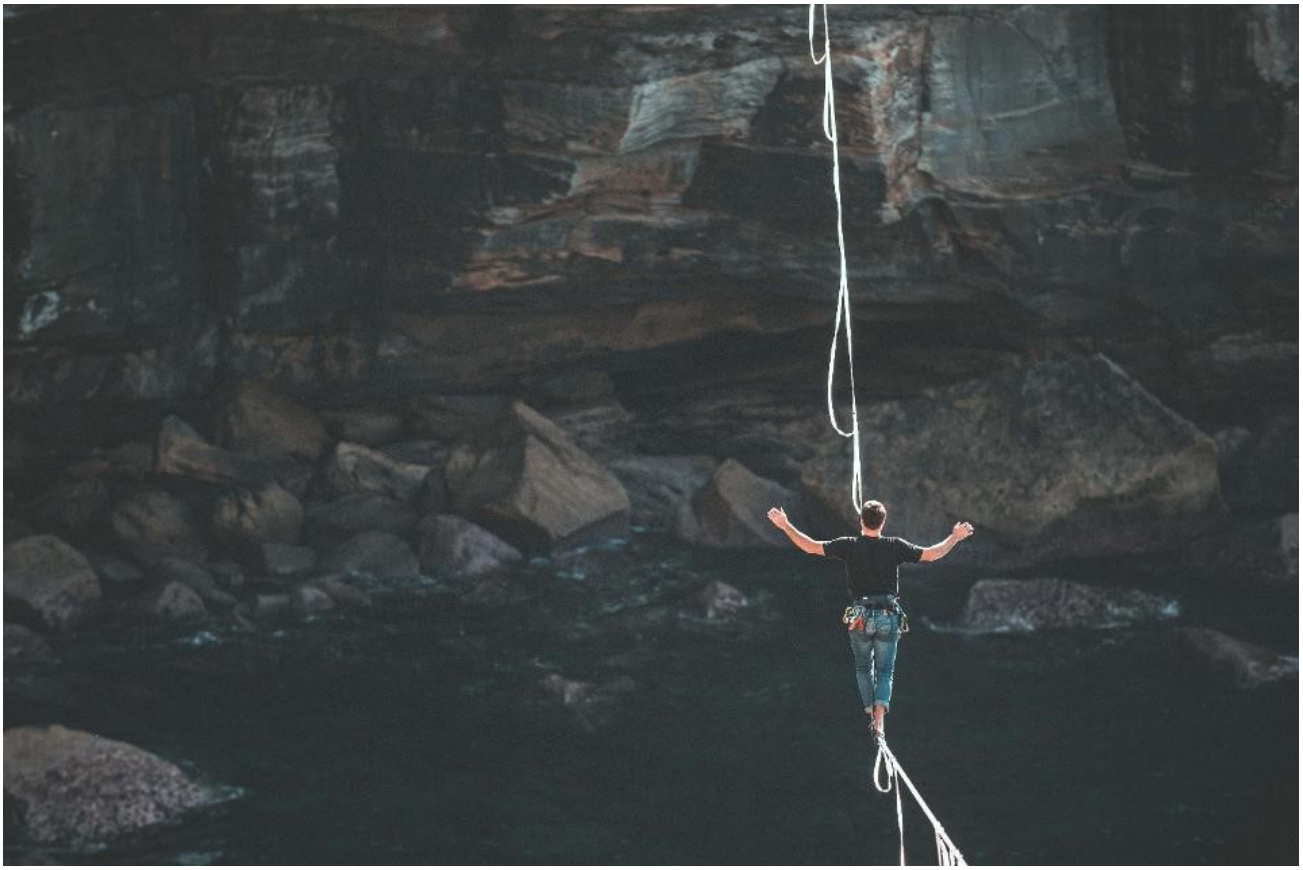
The Risks Of Cash Value Life Insurance

Garrett Gunderson



A large portion of the insurance and investment industry has perpetuated a dangerous narrative, a ... [+] false belief. One where if you want a return you must take higher risks.

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A large portion of the insurance and investment industry has perpetuated a dangerous narrative, a false belief.

One where if you want a return you must take higher risks.

As people have lost money, they have also lost faith in this erroneous philosophy. People value protecting their money, but would still love the possibility of more growth than a CD, savings account, or other fixed income instruments that have had a long track record of low interest rates.

Enter: Index Universal Life

These policies have become the popular choice for cash value insurance. Looking at the illustrations and listening to the sales pitch, I can see why. It has a minimum guarantee. It has upside potential as the market performs. You can overfund beyond the target premium by adding cash, shielding the growth from taxes. If you are healthy enough to get a standard or preferred rating, the cost of insurance is seemingly small, well… up front and with current conditions at least.

If it sounds like there may be a catch, well there is.

Actually a few that you may want to be aware of before making allocations to this type of vehicle: Current costs are not guaranteed, late payments could eliminate guarantees, there are several limits on the upside potential, you give up certain control of your money to the company and can take on unnecessary risk.

Let's begin with how your costs are calculated. There are multiple death benefit options and the one you choose can impact the cost/drag on your policy.

The more cash you have in relation to your death benefit, if you choose option 1 (yes there are several options on how your death benefit grows and costs are calculated), the lower the cost. This is called your net amount at risk, which is the difference between the death benefit minus the cash value. You are only being charged insurance costs on the net amount at risk. Great news.

What happens if you take money from the policy though?

Can that increase your cost of insurance?

Will it impact you if you borrow instead of withdrawal?

These are critical questions to ask in order to design the policy in your favor. If that isn't possible, avoid this vehicle altogether.

You may choose option 2 and this can increase your death benefit as your cash value grows and even allow you to put more money into the plan without triggering the MEC (modified endowment contract) provision that can eliminate some of your tax benefits. On the other hand, this will change the nature of your insurance expenses.

One of the costs is M&E (mortality and expense). The cost of insurance works in 2 ways. As we get older, Universal Life is built really similar to a term insurance chassis- the older you get, the cost of that insurance goes up like an Annual Renewable Term. Because it is an Index Universal Life, they actually charge a bit more for the cost of insurance than most term policies, but people are allocating more dollars to create cash value. As you age, Annual Renewable Term becomes more expensive.

Only 1.1% of term insurance actually pays out according to an executive at Ameritas Life, because they are only issuing it to healthy people and if you live the life expectancy, then they phase/price you out.

Another thing about these Universal Life type policies is the companies implement something called "bundling". They look at all like-people who buy their policies at a similar time, age and health status. Then they say "how many people are dying per 1,000 in that bundle?". Not many early on- but as you get older more people start to die and people abandon the policies because maybe they found something better or they couldn't afford it. This will change the deaths per 1,000 ratio and is likely to increase your future insurance costs.

To see the worst case scenario you can look at the columns of your Index Universal Life illustrations. Note: the right side lists what is currently happening and is the best case scenario as far as expenses are concerned. The left column, circled in red, shows the guaranteed cost.

Prepared for: Male Client
Male Issue Age: 40
Non Tobacco

Specified Amount: $1,000,000
Death Benefit Option: A
State: TX
Initial Monthly Premium: $1,000.00

					Guaranteed Policy Values (1)			Alternate Scale Non-Guaranteed Policy Values 4.35% (2)			Non-Guaranteed Policy Values 6.73% (2)		
EOY Age	End of Year	remium Outlay	Annual Cash Flow	Annual Outlay	Net Death Benefit	Net Account Value	Cash Surrender Value	Net Death Benefit	Net Account Value	Cash Surrender Value	Net Death Benefit	Net Account Value	Cash Surrender Value
41	1	12,000	0	12,000	1,000,000	1,010	0	1,000,000	7,019	0	1,000,000	7,106	0
42	2	12,000	0	12,000	1,000,000	1,872	0	1,000,000	14,211	0	1,000,000	14,557	0
43	3	12,000	0	12,000	1,000,000	2,606	0	1,000,000	21,591	3,391	1,000,000	22,382	4,182
44	4	12,000	0	12,000	1,000,000	3,281	0	1,000,000	29,211	13,171	1,000,000	30,653	14,613
45	5	12,000	0	12,000	1,000,000	3,889	0	1,000,000	37,059	22,109	1,000,000	39,376	24,426
46	6	12,000	0	12,000	1,000,000	4,428	0	1,000,000	45,085	32,625	1,000,000	48,809	36,349
47	7	12,000	0	12,000	1,000,000	4,899	0	1,000,000	53,303	43,333	1,000,000	58,782	48,812
48	8	12,000	0	12,000	1,000,000	5,311	0	1,000,000	61,739	54,259	1,000,000	69,356	61,876
49	9	12,000	0	12,000	1,000,000	5,654	674	1,000,000	70,457	65,477	1,000,000	80,630	75,650
50	10	12,000	0	12,000	1,000,000	5,929	3,439	1,000,000	79,438	76,948	1,000,000	92,626	90,136
		20,000	0	120,000									
51	11	12,000	0	12,000	1,000,000	6,085	6,085	1,000,000	92,573	92,573	1,000,000	109,340	109,340
52	12	12,000	0	12,000	1,000,000	6,081	6,081	1,000,000	106,113	106,113	1,000,000	127,133	127,133
53	13	12,000	0	12,000	1,000,000	5,889	5,889	1,000,000	120,066	120,066	1,000,000	146,080	146,080
54	14	12,000	0	12,000	1,000,000	5,476	5,476	1,000,000	134,444	134,444	1,000,000	166,263	166,263
55	15	12,000	0	12,000	1,000,000	4,812	4,812	1,000,000	149,249	149,249	1,000,000	187,763	187,763
56	16	12,000	0	12,000	1,000,000	3,846	3,846	1,000,000	164,498	164,498	1,000,000	210,683	210,683
57	17	12,000	0	12,000	1,000,000	2,535	2,535	1,000,000	180,177	180,177	1,000,000	235,105	235,105
58	18	12,000	0	12,000	1,000,000	828	828	1,000,000	196,303	196,303	1,000,000	261,149	261,149
59	19	12,000	0	12,000	0	0	0	1,000,000	212,905	212,905	1,000,000	288,957	288,957
60	20	12,000	0	12,000	0	0	0	1,000,000	229,994	229,994	1,000,000	318,666	318,666
		40,000	0	240,000									
61	21	12,000	0	12,000	0	0	0	1,000,000	247,519	247,519	1,000,000	350,372	350,372
62	22	12,000	0	12,000	0	0	0	1,000,000	265,473	265,473	1,000,000	384,224	384,224
63	23	12,000	0	12,000	0	0	0	1,000,000	283,784	283,784	1,000,000	420,340	420,340
64	24	12,000	0	12,000	0	0	0	1,000,000	302,457	302,457	1,000,000	458,921	458,921
65	25	12,000	0	12,000	0	0	0	1,000,000	321,489	321,489	1,000,000	500,194	500,194
66	26	12,000	0	12,000	0	0	0	1,000,000	340,603	340,603	1,000,000	544,211	544,211
67	27	12,000	0	12,000	0	0	0	1,000,000	360,153	360,153	1,000,000	591,526	591,526
68	28	12,000	0	12,000	0	0	0	1,000,000	380,201	380,201	1,000,000	642,505	642,505
69	29	12,000	0	12,000	0	0	0	1,000,000	400,771	400,771	1,000,000	697,533	697,533
70	30	12,000	0	12,000	0	0	0	1,000,000	421,924	421,924	1,000,000	757,064	757,064
		60,000	0	360,000									
71	31	12,000	0	12,000	0	0	0	1,000,000	443,611	443,611	1,000,000	821,560	821,560
72	32	12,000	0	12,000	0	0	0	1,000,000	465,788	465,788	1,007,489	891,584	891,584
73	33	12,000	0	12,000	0	0	0	1,000,000	488,294	488,294	1,073,685	967,284	967,284
74	34	12,000	0	12,000	0	0	0	1,000,000	511,192	511,192	1,143,008	1,048,631	1,048,631
75	35	12,000	0	12,000	0	0	0	1,000,000	534,551	534,551	1,215,654	1,136,125	1,136,125
76	36	12,000	0	12,000	0	0	0	1,000,000	558,410	558,410	1,291,859	1,230,342	1,230,342
77	37	12,000	0	12,000	0	0	0	1,000,000	582,828	582,828	1,397,826	1,331,263	1,331,263
78	38	12,000	0	12,000	0	0	0	1,000,000	607,797	607,797	1,511,292	1,439,325	1,439,325
79	39	12,000	0	12,000	0	0	0	1,000,000	633,315	633,315	1,632,729	1,554,980	1,554,980
80	40	12,000	0	12,000	0	0	0	1,000,000	659,407	659,407	1,762,630	1,678,696	1,678,696
		480,000	0	480,000									

IUL Example

Garrett Gunderson

Prepared for: Male Client
Male Issue Age: 40
Non Tobacco

Part 2

Specified Amount: $1,000,000
Death Benefit Option: A
State: TX
Initial Monthly Premium: $1,000.00

					Guaranteed Policy Values (1)			Alternate Scale Non-Guaranteed Policy Values 4.35% (2)			Non-Guaranteed Policy Values 6.73% (2)		
EOY Age	End of Year	Premium Outlay	Annual Cash Flow	Annual Outlay	Net Death Benefit	Net Account Value	Cash Surrender Value	Net Death Benefit	Net Account Value	Cash Surrender Value	Net Death Benefit	Net Account Value	Cash Surrender Value
81	41	12,000	0	12,000	0	0	0	1,000,000	686,211	686,211	1,901,527	1,810,978	1,810,978
82	42	12,000	0	12,000	0	0	0	1,000,000	713,837	713,837	2,049,951	1,952,334	1,952,334
83	43	12,000	0	12,000	0	0	0	1,000,000	742,584	742,584	2,208,496	2,103,330	2,103,330
84	44	12,000	0	12,000	0	0	0	1,000,000	772,762	772,762	2,377,767	2,264,540	2,264,540
85	45	12,000	0	12,000	0	0	0	1,000,000	804,724	804,724	2,558,368	2,436,541	2,436,541
86	46	12,000	0	12,000	0	0	0	1,000,000	838,929	838,929	2,750,908	2,619,912	2,619,912
87	47	12,000	0	12,000	0	0	0	1,000,000	875,998	875,998	2,956,000	2,815,238	2,815,238
88	48	12,000	0	12,000	0	0	0	1,000,000	916,779	916,779	3,174,279	3,023,123	3,023,123
89	49	12,000	0	12,000	0	0	0	1,010,450	962,333	962,333	3,406,402	3,244,193	3,244,193
90	50	12,000	0	12,000	0	0	0	1,061,238	1,010,703	1,010,703	3,653,058	3,479,103	3,479,103
		600,000	0	600,000									
91	51	12,000	0	12,000	0	0	0	1,113,490	1,060,466	1,060,466	3,914,961	3,728,535	3,728,535
92	52	12,000	0	12,000	0	0	0	1,157,360	1,112,847	1,112,847	4,157,537	3,997,632	3,997,632
93	53	12,000	0	12,000	0	0	0	1,203,298	1,168,251	1,168,251	4,417,658	4,288,988	4,288,988
94	54	12,000	0	12,000	0	0	0	1,251,712	1,227,168	1,227,168	4,697,817	4,605,703	4,605,703
95	55	12,000	0	12,000	0	0	0	1,303,092	1,290,190	1,290,190	5,001,030	4,951,515	4,951,515
96	56	12,000	0	12,000	0	0	0	1,369,192	1,355,635	1,355,635	5,374,731	5,321,516	5,321,516
97	57	12,000	0	12,000	0	0	0	1,437,907	1,423,671	1,423,671	5,774,859	5,717,682	5,717,682
98	58	12,000	0	12,000	0	0	0	1,509,323	1,494,379	1,494,379	6,203,187	6,141,769	6,141,769
99	59	12,000	0	12,000	0	0	0	1,583,520	1,567,841	1,567,841	6,661,593	6,595,637	6,595,637
100	60	12,000	0	12,000	0	0	0	1,660,581	1,644,140	1,644,140	7,152,064	7,081,251	7,081,251
		720,000	0	720,000									
101	61	12,000	0	12,000	0	0	0	1,740,589	1,723,356	1,723,356	7,676,696	7,600,689	7,600,689
102	62	12,000	0	12,000	0	0	0	1,823,674	1,805,618	1,805,618	8,237,934	8,156,370	8,156,370
103	63	12,000	0	12,000	0	0	0	1,909,928	1,891,018	1,891,018	8,838,190	8,750,683	8,750,683
104	64	12,000	0	12,000	0	0	0	1,999,443	1,979,647	1,979,647	9,480,016	9,386,154	9,386,154
105	65	12,000	0	12,000	0	0	0	2,092,309	2,071,593	2,071,593	10,166,107	10,065,452	10,065,452
106	66	12,000	0	12,000	0	0	0	2,188,621	2,166,951	2,166,951	10,899,331	10,791,417	10,791,417
107	67	12,000	0	12,000	0	0	0	2,288,467	2,265,809	2,265,809	11,682,695	11,567,025	11,567,025
108	68	12,000	0	12,000	0	0	0	2,391,934	2,368,251	2,368,251	12,519,366	12,395,412	12,395,412
109	69	3,407*	0	3,407	0	0	0	2,490,861	2,466,199	2,466,199	13,404,298	13,271,582	13,271,582
110	70	0*	0	0	0	0	0	2,589,979	2,564,335	2,564,335	14,345,458	14,203,423	14,203,423
		819,407	0	819,407									
111	71	0*	0	0	0	0	0	2,692,493	2,665,835	2,665,835	15,349,566	15,197,590	15,197,590
112	72	0*	0	0	0	0	0	2,798,669	2,770,960	2,770,960	16,421,622	16,259,031	16,259,031
113	73	0*	0	0	0	0	0	2,908,382	2,879,587	2,879,587	17,564,613	17,390,705	17,390,705
114	74	0*	0	0	0	0	0	3,021,682	2,991,764	2,991,764	18,782,699	18,596,732	18,596,732
115	75	0*	0	0	0	0	0	3,138,608	3,107,533	3,107,533	20,080,215	19,881,400	19,881,400
116	76	0*	0	0	0	0	0	3,259,196	3,226,927	3,226,927	21,461,657	21,249,165	21,249,165
117	77	0*	0	0	0	0	0	3,383,467	3,349,967	3,349,967	22,931,686	22,704,640	22,704,640
118	78	0*	0	0	0	0	0	3,511,433	3,476,667	3,476,667	24,495,115	24,252,589	24,252,589
119	79	0*	0	0	0	0	0	3,643,095	3,607,024	3,607,024	26,156,895	25,897,916	25,897,916
120	80	0*	0	0	0	0	0	3,778,436	3,741,025	3,741,025	27,922,107	27,645,650	27,645,650
		819,407	0	819,407									

IUL Example (con't)

Garrett Gunderson

It is highly unlikely, nearly impossible, that the guaranteed cost will go right to the maximum in the beginning. That happens over a longer period of time. But because most insurance agents generally haven't been selling this for 20 years, they haven't watched these things *implode* and *explode*. They haven't watched policies from the early 80's that went to the guaranteed cost. And on the guaranteed cost side you'll see that those costs went up so high that they destroyed the *cash value*. As it eats away the cash value then there is even more cost, because now there is more net amount at risk. Hence the worst case scenario and problem.

I recently sat down with the creator of Truth Concepts software (truthconcepts.com), Todd Langford, to further illustrate what problems may arise with Indexed Universal LIfe.

So buyer beware.

These may not be what you think and Todd brilliantly unveils the problems lurking for policyholders that can be detrimental and erode your wealth.

Garrett: Todd, can you give me an overview of why people aren't informed of the issues and potential problems with Equity Indexed Universal Life?

Todd: Insurance companies have put numerous pages on the front of Equity Indexed Universal Life (EIUL) illustrations that show the main issues, but most people (by design) will not take the time to read and understand what these pages are saying. I would encourage everyone to read those pages thoroughly before depending on an EIUL policy to increase your assets or protect your family. Similarly, Universal Life (UL) and its cousin Variable Universal Life (VUL) have some of the same problems.

Garrett: What are the top things people should look for or the main problems you see with this product?

Todd:

#10 Internal costs are not guaranteed

#9 Mortality charges are not guaranteed

#8 Market drops cause double pain

#7 Late premiums kill any guarantees

#6 Dividends from the index don't get credited

#5 Participation ratios are often less than 100%

#4 Returns are usually capped at various interest rates

#3 Guarantees are not calculated annually

#2 All of the above can be changed by the company

#1 The risk is shifted back to the insured

Garrett: Can we look at each of these individually and give more details of what this means, how it impacts the policy and most importantly impacts those that own these policies?

Todd: Sure.

#10 Internal costs are not guaranteed: Internal administration fees charged against cash value on any type of Universal Life policy and shown on illustrations are run under current expense levels, but those can change at the discretion of the company. Since the insurance company uses this money to run its operations, as the prices of office supplies and real estate go up, they may choose to adjust these internal costs after you have bought the policy.

#9 Mortality charges are not guaranteed: Mortality changes, what the insurance company charges for the death benefit are removed from the cash value or paid by premiums. In UL, these pay for annually increasing term insurance costs. This is true for any type of UL, no matter what the side fund is invested in. The cost for this one year term insurance can be changed at any time.

#8 Market drops cause double pain: With VUL, market drops affect the side fund negatively no matter what the side fund is invested in. Since the death benefit is comprised of the One Year (or annually increasing) Term Insurance, plus the side fund, any market drop causes double pain. Markets can drop regardless of whether they are supported by stocks or money markets. When the side fund is reduced by a drop in the market or current interest rates, it now has less value so more Term Insurance must be bought to make up the difference which further reduces the side fund. Consequently you have double pain; less cash value and higher costs.

#7 Late premiums kill any guarantees: Any late premiums remove any guarantees in the policy. In most UL policies, even if the premium is finally paid, once it is late, the insurance company is off the hook for supporting any guaranteed premiums, cash value amounts or death benefits. In many cases, the insured may not even know that a premium was late and that the guarantees have been forfeited. Thinking about the time frame of a 50 year policy paid monthly (600 payments) ask yourself what the likelihood is of a mistake being made by the premium payer, their bank, the post office, the insurance company clerks or anyone else along the way.

#6 Dividends from the index don't get credited: Equity Indexed Universal Life policies provide the policy holder no credit for any dividends from the stocks making up the index. The side fund of an EIUL isn't actually invested in the index; instead the index is used to determine the gross crediting rate for the side fund. If money were actually invested in the index, the investor would get both the change in Net Asset Value (whether up or down) AND the dividend income. However, in the case of EIUL, only the change in value of the index is the determining factor and the dividend is left out of the calculation entirely.

#5 Participation ratios are often less than 100%: Participation ratios are often less than 100%. As mentioned directly above, the side fund is not invested directly in the index and many insurance companies only credit a certain percentage of the increase in the market. Known as the participation ratio, this is often reported at 80% or less meaning you are getting only 80% of the increase in the market.

#4 Returns are usually capped at various interest rates: Capping returns in order to keep high returns in the market from crediting too much to the side fund is a strategy many insurance companies use. The maximum return they'll give credit for may be at a certain percentage rate even though the index may have generated a higher percentage rate.

#3 Guarantees are not calculated annually: Guaranteed minimum returns are not always calculated annually. Most EIUL policies have a guaranteed minimum return so that if the index drops below this rate, the insurance company will still credit at the guaranteed minimum rate. However, with some policies this guarantee is not applied annually but instead over an "indexing period" which could be 5-10 years. So you could have negative years in the index (below the guaranteed minimum rate) which would be applied to the side fund. This would cause a further reduction of value in excess of the guaranteed minimum rate in one particular year and as long as the overall average rate for the entire indexing period is not less than the guaranteed minimum rate, this would still count as meeting the minimum.

For example, if the minimum guaranteed rate is 2% inside a 5 year indexing period, you could have crediting rates of +13, -10, +10, -8 and +9% which would validate the promised guarantee because it would average more than 2% per year over the 5 years. The implication is that you cannot have a negative return, but as shown in the example below, you can have a negative return as long as the guarantee is not calculated annually.

You'll notice another example below of the same interest rates, but with $100,000 of existing value instead of $10,000 per year of cash flow into the account.

#2 All of the above can be changed by the company: At the discretion of the company any of the above factors can be changed at any time for the benefit of the company even after the policy has started. This is really one of the scariest aspects of all types of UL. There is no way to calculate what the outcome might be. Even if you analyzed the policy under the current structure and found it to be a viable tool, future changes could cause future problems.

#1 The risk is shifted back to the insured: Where as typically the point of all insurance purchased is to shift the risk from the insured to the company, all types of UL shift the risk backwards or from the insurance company to the insured.

Garrett: Todd, thank you providing the rest of the story and sharing the pitfalls of a popular, yet misunderstood product.