



## **Consumer Issues Associated with Guaranteed Universal Life Policies**

### **Table of Contents**

Executive Summary .....	2
Background .....	3
Industry Studies.....	4
Market Conduct Issues.....	8
Possible Regulatory Action .....	10

For Additional Information Contact:  
Robert Panah, CPA, CFE, CISA, FLMI  
Peter Klein, CFA

## **Consumer Issues Associated with Guaranteed Universal Life Policies**

### **Executive Summary**

Guaranteed Universal Life (GUL) policies are marketed as simple permanent insurance. GUL policies generally have little or no cash value compared to other products which allows the carriers to offer cheaper premiums. As long as the policyholder makes timely minimum premium payments, the secondary or no lapse guarantee remains in effect. However, if a premium comes in early, partial or late, the variance can have an adverse impact on the performance of the policy resulting an entirely different set of charges, loads and rates. Since GUL policies accumulate minimal cash value, carriers rely on shadow accounts to keep the policies in force. When the policies eventually fall off track, depending on the policy, premiums can significantly increase and in some cases, result in more premiums than death benefits over the life of the policy.

Although the policyholders assume the fiduciary duties, they are often elderly and not qualified to understand the complexities of the product. Agents are typically out of the picture after the sale is made and carriers provide limited information on an ongoing basis. Carriers do not notify policyholders when their policies are off track and continue to collect premiums until the policies eventually lapse through zero or negative shadow account balances. Additionally, unless specifically requested, carriers do not provide updated illustrations so that the policyholder can confirm the policy is on track and that it continues to meet their financial planning objectives.

The underlying policy engines behind GUL policies are complex. The complexities of the policies were further exacerbated by the prolonged low interest rate environment. Certain GUL policies issued in 2001-2005 were aggressively priced, and chronically underfunded. But neither the carrier nor the agent made any effort to alert the insured that these policies needed to be administered with a higher protocol given their underfunding and vulnerabilities to losing their guaranteed feature.

Certain segments of the population have enjoyed substantial decline in mortality due to advances in medical science and treatment but that long term trend hasn't been priced in the cost of insurance (COI) charges by carriers. Rather the opposite has occurred, some carriers have been systematically increasing the COI charges on existing policies some of which have been in place for decades. There have been recent policyholder lawsuits against carriers with respect to these products which (i) challenged why the COI was increased when mortality has improved and (ii) why the COI was not reduced for the same reason. Insurer practices with respect to the COI charges may be a symptom of a bigger issue for these products because of the complexity of the GUL engine combined with the prolonged low interest rate environment.

Based on limited industry studies and information available from contract holders, we expect a significant number of GUL policyholders are not getting the benefit of their bargain. Insurance regulators may want to (i) determine the magnitude of this issue on the policyholders within their state and (ii) correct business practices as they deem necessary.

## **Background**

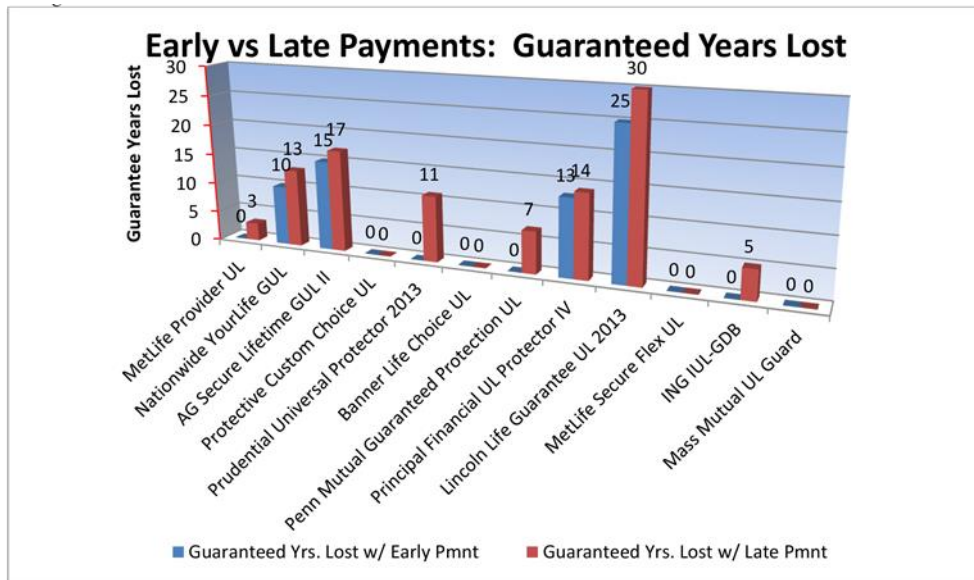
- GUL policies are marketed as simple permanent insurance. GUL policies generally have little or no cash value compared to other products which allows the carriers to offer cheaper premiums. As long as the policyholder makes timely minimum premium payments, the secondary or no lapse guarantee remains in effect.
- Historically, carriers have used “Shadow Accounts” to fund UL products that have premium or interest credited to them only for the purpose of keeping the policy in force. The policyholder does not have access to the amount credited to the shadow account. Shadow accounts allow the carriers to charge lower premiums while keeping the policies in force.
- Shadow accounts have their own sets of charges and crediting rates that are different from the actual policy. Zero or negative shadow account values have an adverse impact on the guaranteed death benefit guarantees.
- Carriers have used single tier and two-tiered shadow accounts to further protect the policy structure.
- Shadow accounts mask strained assumptions in these products, and allow insurers to underprice products and provide guaranteed rates with essentially little or no cash value buildup in the accounts.
- The actuarial guidelines were improved with AXXX and other 2012 initiatives but the use of shadow accounts still continues and there is a significant legacy block. After the AG 38 revisions, carriers no longer use two tiered shadow accounts effective 1/1/2013.
- The complexity in the products stems from the pricing precision as well as strategies to minimize AG 38 reserves. This complexity is hidden from the consumer who does not understand that GUL product guarantees change significantly when payment patterns are different from what was on the illustration.
- Agents and brokers do not do a good enough job of explaining these products to consumers as evidenced by the significant number of policies that are off track. Agents may not have a good understanding of the complexities of the products.
- Agents are often no longer involved with the customer or do not provide updated illustrations on the product once the sale is made.
- Agents often retire or are no longer in contact with consumers. Additionally, there are no financial incentives for them to remain in contact with the policyholder.
- GUL products generally have little or no cash value which makes timeliness of premium payments critical to maintaining the guaranteed premium.

**Industry Studies**

Below are the results of two industry studies conducted after 2010 that help illustrate how GUL policies go off track when premiums are not paid exactly in accordance with the illustrations. Although we only gained access to summaries of these studies, they indicate this is an industry-wide issue that impacts policyholders in every state.

**Met Life Study**

- For the majority of the products in the marketplace, timeliness of payments (both early and late payments) have a significant impact on the guarantee as illustrated by the study below by Met Life:



The study compared on-time payments in accordance with the illustration to two scenarios (i) Pay early: double premium in year 11, no premium in year 12 then premium payment normalcy reoccurring from year 13 to maturity and (ii) Pay late: no premium in year 11, double year 12’s premium followed by premium normalcy from year 13 to maturity.

**Nationwide Study**

- Nationwide conducted an audit of 8,100 of its in-force GUL policies. By way of background, Nationwide is a newer competitor in the GUL business and as a result did not make use of the two-tiered shadow accounts. Even with that added conservatism relative to the other competitors with the legacy blocks, the study found that 31% of the policies were off track. The off track policies resulted from early payment (53%), skipped premium (29%) and insufficient account structures.
- When these policies enter lapse pending status, there is a large penalty in the form of higher premiums which in later years of the policy can result in a significant portion of the face amount of the policy. See our attached real life illustration below.

Real Life Study

- Below is a real life example of an updated illustration requested on behalf of an 85 year old GUL owner whose policy went off track due to payment patterns that were different than the illustration. It is important to point out the following:
  - The illustration was only requested because the policyholder’s circumstances had changed and he was looking to the life settlement market for a solution.
  - Had he not requested the revised illustration, he would not have known his policy was off track.
  - The insurance company was continuing to bill him his \$25k annual premium even though his policy was off track and did not communicate such to the policyholder.
  - He learned that to keep the same death benefit, his premiums would increase at least three fold, resulting in \$500k more in premium payments than the death benefit if he lives to 100.

**XXXXXXX INSURANCE COMPANY**

**XXXX Survivor (SM) XL**

POLICY #XXXXXX

ISSUED APRIL 11, 2004

1ST JT. INSURED: ROBERT XXXXX

FACE AMOUNT: \$ 1,000,000

1ST JT. INSURED: MALE AGE: 76 PREFERRED NONSMOKER

PREMIUMS PAID TO DATE: \$ 240,949

1ST JT. INSURED:

PREMIUMS PAYABLE: SEMI-ANNUAL

2ND JT. INSURED: MARILYN XXXXX

2ND JT. INSURED: FEMALE AGE: 73 UNINSURABLE NONSMOKER

2ND JT. INSURED:

This is an updated illustration to age 100 requested by the insured's advisors. It indicates the \$25k premiums will have to increase to \$87k to maintain current benefits. Total premium outlay will exceed the death benefit by approximately \$500k

CURRENT WEIGHTED INTEREST RATE: 4.00%

PROJECTED VALUES AT

NON-GUARANTEED PROJECTED

NON

GUARANTEED INTEREST RATE (4.00%)

VALUES AT ILLUSTRATED INTEREST



END OF POLICY	GUAR. INTR.	PREMIUM OUTLAY	ANNUAL WITHDRAWAL	GUARANTEED MONTHLY DEDUCTIONS			RATES AND MONTHLY DEDUCTIONS		
				CASH VALUE	ACCUM VALUE	DEATH BENEFIT	CASH VALUE	ACCUM VALUE	DEATH BENEFIT
12	85	4.00% (P) 7,000	0	0	514	1,000,000	0	514	1,000,000
13	86	4.00% 87,128	0	0	0	0	22,504	38,854	1,000,000
14	87	4.00% 87,128	0	0	0	0	56,872	70,892	1,000,000
15	88	4.00% 87,128	0	0	0	0	87,077	98,757	1,000,000
16	89	4.00% 87,128	0	0	0	0	122,456	131,796	1,000,000
17	90	4.00% 87,128	0	0	0	0	154,788	161,798	1,000,000
18	91	4.00% 87,128	0	0	0	0	173,706	178,376	1,000,000
19	92	4.00% 87,128	0	0	0	0	188,110	190,450	1,000,000
20	93	4.00% 87,128	0	0	0	0	197,416	197,416	1,000,000
21	94	4.00% 87,128	0	0	0	0	198,497	198,497	1,000,000
22	95	4.00% 87,128	0	0	0	0	192,686	192,686	1,000,000
23	96	4.00% 87,128	0	0	0	0	178,394	178,394	1,000,000
24	97	4.00% 87,128	0	0	0	0	153,800	153,800	1,000,000
25	98	4.00% 87,128	0	0	0	0	118,233	118,233	1,000,000
26	99	4.00% 87,128	0	0	0	0	69,084	69,084	1,000,000

- As illustrated in the real life example above, there is a potential to trigger contractual clauses that could, in fact, lead to additional billing beyond the original guaranteed premium quoted at issue.
- Also it is worth noting the policy had essentially no cash value for the first ten years and only began to accumulate a cash value after the premiums tripled.
- Additionally, this policyholder received the following note inside his latest statement: **"Total premiums paid as of this illustration date will not produce a viable illustration."** The 85 year-old policyholder did not understand the comment which implies the policy may have lapsed. Accordingly, the language is not only confusing to the well-educated reader, it is even more confusing to the elderly policyholder without proper representation. Further investigation is currently underway with respect to the details of this policy.

Other Commentary Based on the Studies

- In summary, if a premium comes in early, partial or late, the variance can move the policy into an entirely different track with different charges, loads and rates. How the policy behaves at that point will depend on the structure of the policy and the shadow accounts which can keep the policy in force for a period of time before it lapses or requires higher premium payments to keep the same death benefit.

- Much like long-term care, the initial assumptions, including interest rates and mortality assumptions may have been too aggressive relative to reality...people are living longer and interest rates have remained low for a prolonged period of time. Revisions to actuarial guidelines helped curb some of these aggressive assumptions in newer products.
- Carriers benefit from fees and premiums collected from policies which have essentially lost their guaranteed premium feature due to untimely payment patterns. Conversely, policyholders are unaware of the changes to the guarantees and may continue payments on policies that have lost their guarantee.
- Policyholders are not aware of this until at some point, the carriers send them a notice of premium increase which essentially turns their policies into a term life policy (and in many cases, premiums exceed the death benefit over the expected survival period).
- There is a disintermediation risk for carriers when policyholders are educated through updated illustrations when their policies go off track. Healthier policyholders can leave for new carriers.
- Policyholders need to get periodic illustrations and consultation to ensure these policies are still on track and that they continue to meet their financial planning goals as most of their circumstances change. The most significant circumstance is often that they outlive to expected policy term.
- Administration practices of carriers do NOT include sending notices to clients and producers about partial, skipped, early and late premium payments.

## **Market Conduct Issues**

GUL policies have been in force for nearly two decades. Legacy inforce blocks reflect the issues identified above. These issues are especially magnified in policies with two-tiered shadow accounts written prior to 2013.

The issues impact all policyholders but mostly the older demographic because of the lack of knowledge, lack of proper representation, lack of understanding to request updated illustrations to ensure the policies continue to fit the financial planning goals. The fiduciary responsibility is held by the policyholders, even though they are often older and are unable to understand the complexities of the product without expert advice. The fiduciary issue for GUL is conceptually consistent with the issues raised with the recent DOL Fiduciary rulings.

The results of the studies above indicate this is an industry-wide issue that impacts policyholders in every state.

- Agents may not be properly trained to communicate:
  - Complexities of the products despite the simple illustrations.
  - How easily policies can go off track and result in significant additional premiums.
  - Simple illustrations often appear low risk but may mask large underlying complexities.
  - Policyholders should request periodic updated illustrations (every 1-3 years) to ensure:
    - The policy is performing as intended.
    - The policy continues to meet the financial planning goals.
    - They consult with a knowledgeable advisor throughout the life of the policy.
- Carriers may not be performing adequate due diligence, preparing proper marketing material or conducting adequate follow-up to ensure the agents have adequate training and marketing material and that the consumer receives adequate communication with respect to the risks and complexities associated with this product.
- Carriers may not have policies or procedures in place to notify consumers when their policies are off track.
- Carriers may not know internally the extent of GUL products that are off track and why.
- Carriers appear to be continuing to invoice consumers for the premiums on GUL products even when the policy is off track due to early or late premium payments. Policies can be essentially lapsed or underfunded but still active and requesting premiums.



- Agents and carriers appear to give the consumer the impression that once the policy is set, then no further action is necessary.
- Although by contract, the consumer assumes responsibility for fiduciary duties, they are not adequately advised on the complexities of the product. This risk is especially magnified for the elderly. In the absence of fiduciary responsibility by carriers and agents, there does not appear be adequate communication to the consumer about the need for continued representation and advice with respect to these policies.
- Often when carriers make significant changes to the policy that is material to the consumer, it is often not clearly communicated in a manner that they can understand. The consumer, especially the elderly need experienced professionals to understand the communication from the carriers. Nobody is assuming responsibility for this (agents/carriers).
- The insurance companies have all the information and the policyholder and agent only have the information and illustrations at the inception of the policy. Thereafter, the agents typically go away because there is no further commission incentive and carriers do not step in to inform the policyholders other than the fine print in the policy. Knowing this, the carriers would want to take inventory of GUL policies that are off track and take steps to remediate this issue.
- There is a fair chance that a significant number of GUL policies are off-track and that the penalties for being off-track are probably going to be steep if they're left unchecked.
- Changes in premium patterns (early payment, late payment, skipped payments) create significant divergences in the policies that are often not properly communicated to the policyholders. Catchup premiums can be 6-10 times the original premium in early years and more than half of the face amount in later years. The extent of catch up premiums depends on the shadow accounts.
- Other than the fine print in statements, and eventual grace period notices, carriers are not required to communicate the material changes in a manner that is understood by the policyholders.
- Policyholders are often the elderly who need additional support to ensure they are making the best decision and also to help them periodically re-evaluate their policies.

### **Possible Regulatory Action**

Regulators can take steps to ensure carriers help the policyholders who can't help themselves by (i) identifying the magnitude of the issue; (ii) correcting business practices to ensure the policyholders get the benefit of their bargain.

- Send out a well-thought out data call to identify:
  - Magnitude of this exposure within the state's domestics
  - Magnitude of legacy business, including the composition of the business (single shadow account or two-tiered shadow accounts)
  - Demographics impacted by the legacy business (are there a disproportionate amount of elderly policyholders?)
  - Product types and features of the products.
  - Information on the administration of these policies including the impact of partial, skipped, early or late premium payments on the policies.
  - Whether notices are sent to producers or policyholders regarding the impact of partial, skipped, early or late premium payments when they occur. Provide examples of these notices.
  - Types of communication with policyholders in periodic statements, when policies are off track, when they are about to lapse etc.
  - Frequency and results of internal audits of GUL policies.
  - If not otherwise provided, obtain:
    - Number and key statistics for policies that are essentially lapsed or where premiums are being paid toward essentially nothing...for example would the policyholder's statement include a statement similar to: "Total premiums paid as of this illustration will not produce a viable illustration." This would include policies that are on the verge of or have already essentially turned into term policies.
    - Number of policies (and related statistics) where the guaranteed premium is not adequate to support the death benefits without additional premiums.
    - Breakdown of current UL products offered, key features and use of shadow accounts.
    - Marketing material for current and legacy GUL products.
    - Overview of the training program for agents selling GUL products.
    - Information on distribution channels for GUL products: breakdown of IMO's, internal sales force, independent agents, etc. Historic sales information by distribution channel.
- Analyze the results of the data call and if appropriate, commission additional market conduct procedures in connection with a regular or target market conduct examination.
- Depending on the results, consider expanding this nationally through MAWG.

- Corrective actions would vary depending on the results of the market conduct review. They could include asking the carriers to provide updated illustrations on a periodic basis with proper communication so that the policyholders could:
  - Evaluate whether the policy continues to meet the current circumstances. (The insurance company cannot stay engaged with the policyholder to understand their changing circumstances but as the holder of the data/information, they can provide the information so that the policyholder has a chance to get proper advice.)
  - Compare what was promised in the illustration with what actually happened with the policy and explain the differences.
- Carriers could offer a 1035 tax free exchange in circumstances where the policyholders did not get the benefit of their bargain.
- Carriers could improve training and marketing activities as well as communications with the policyholders depending on the nature of the findings.