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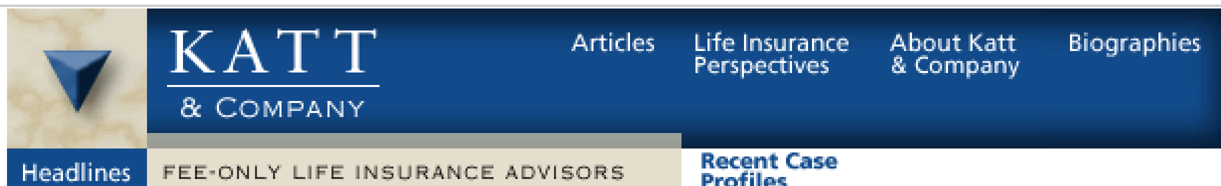

Katt & Company is a national fee-only life insurance advising firm. The June 2002 Forbes magazine, and a July 16, 2003 Wall Street Journal article, name Peter Katt as one of only four nationally recognized advisors. The Forbes article states that, "... advisers are well worth the money... These savants are working for no one but you..." I enjoy writing Perspectives and columns for Journal of Financial Planning, AAII Journal, AICPA Insider and Forbes.com because the difficult act of expressing ideas in writing requires that we wrestle them to the ground to find clarity. Visit our website www.peterkatt.com.

Index Universal Life - Real or Liar's Poker?

Several times a month I get a call from a frustrated life insurance agent complaining that a perfectly good current assumption universal life (UL) or whole life (WL) policy they sold many years ago has been replaced with index universal life (IUL) policy that has been illustrated by a new agent with indexed crediting rates of around 8.5% - some with even higher bonus interest rates. Using such high crediting rates on an illustration makes it seem that IUL is a much better deal. Not likely. I share these agents' frustrations. I do not believe IUL will actually perform anything close to what is illustrated. I offer this challenge to any

company, or agent, selling IUL. Send me actual redacted policy statements for at least a seven year period on several policies so I can match up what the indexes were during that period and the actual cash surrender value produced. If they can show me that things match up I will offer a professional apology. Until then, mark me down as extremely skeptical about IUL.

Current assumption UL and WL insurance refers to cash value policies whose future performance depends on future interest crediting and dividend rates. Changes in crediting rates and dividends will have an effect on that policy's performance compared to earlier illustrations. Focusing on current assumption UL, if crediting rates decrease this would mean policyowners should raise their target premiums. If crediting rates increase premiums could be decreased. When making a purchase decision, generally the higher the crediting rate the better the proposal appears. Consumers and advisors need to be wary, however, of illustration tricks that may make some proposals look better than they are likely to be. This was a common occurrence in the 1980s.

I believe misleading life insurance illustrations are back and buyers are again being subjected to policy performance promises that are quite unlikely to be realized. As noted, current assumption UL depends on future interest rates, and to a lesser degree future mortality experience. During the late 1980s and 1990s many companies used illustration gimmicks to make their policies appear to have fewer premiums or create higher values than their current pricing could provide. Among the common techniques used: bonus interest in five or 10 years; lapse-supported pricing; and return of mortality costs after 10 or 20 years. None of these tricks were guaranteed and I never saw one of the gimmicks actually produce better medium- or long-term values versus companies that didn't resort to such illustration gimmicks. In fact, it is my sense that companies that don't use such tricks produce far superior value for policies.

The illustration wars of the 1980s and 1990s were such a problem that the life insurance industry finally moved to curtail such abuses by promulgating model regulations for life insurance illustrations in 2001. Under the regulations, interest rates embedded into the illustrations are not supposed to be "...greater than the earned interest rate underlying the disciplined current scale." The *disciplined current scale* requires insurers to use non-guaranteed elements that are "...reasonably based on actual recent historical experience..."

The new version of illustration *liar's poker* appears to be IUL. *Index* refers to interest crediting rates that are determined by reference to some stock index. I have seen illustrated rates as high as 8.5% that also included a 0.5% bonus rate starting in the 11th policy year for illustration purposes. The problem is that index premiums collected are not being invested in stocks. One company selling a good deal of IUL has an investment portfolio containing 97% fixed income instruments. The sellers of IUL claim they are able to provide such high potential returns by using various hedging techniques to cover returns that are much larger than what their investment portfolios appear to be able to produce. Even if companies have actually designed hedging formulas, such exotic strategies are notoriously inaccurate. MF Global is the most recent example of how financial wizards often outsmart themselves. It is a mystery how IUL, with the mirage of much higher illustrated crediting rates, are in compliance with illustration regulations. They certainly are an unfair mirage advantage over conventional current assumption UL policies.

I think it is very likely that IUL will turn out to be just a marketing gimmick to justify illustrating much higher interest crediting rates than a company's investments can possibly sustain. As noted this provides an unfair competitive advantage to sell more policies. Sales pitches using 8% and 9% crediting are actually backed up by such contract language as, "...the annual index growth that will be recognized in the calculation of the index earnings for an equity indexed segment on a segment

anniversary. We will determine in advance the participation rate applicable to each equity indexed segment for each twelve month period and will communicate it to you in an annual report or in notices to you." HUH? This suggests the insurance company can credit whatever they want. IUL appears to reawake illustration wars of the recent past. I see no logical reason why they will provide better actual performance versus conventional market-priced UL and WL policies.

I have noticed that IUL policies are being used in conjunction with premium financing and this could turn into a disaster for buyers. Premium financing is a scheme that promises free life insurance by financing all premiums and interest costs, with the loan being paid back via the death benefits, and the net death benefits going to the policy's beneficiary. I have not seen premium financing work when insureds live to around life expectancy. The collateral requirements of the lender exceed the cash values and buyers end up defaulting and having to pay back the huge loans. This has always been completely unexpected. I had one case in which the additional collateral was going to consume the insured's entire net worth within another six years, taking him to age 86, well within his life expectancy.

The premium finance proposals look great because IUL uses a higher illustrated crediting rate than the assumed interest costs to finance premiums and the interest. This makes the premium financing sale spreadsheets appear to provide permanent life insurance regardless how long insureds live. As noted above, I am very skeptical that the IUL returns are going to be anything close to what is illustrated, so I am concerned that IUL will entice even more consumers into buying into premium financing schemes that can absolutely destroy the serenity of old age.

Bottom line - be wary of IUL claims. Don't replace fair priced current assumption UL or WL based on what may be faux promises. Especially be cautious when the high illustrated crediting rates are an integral part of a proposed premium financing proposal.

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Katt & Company • 890 Treasure Island Drive • Mattawan, MI 49071
Phone: 269.372.3497 • Fax: 269.372.4681
Email: pkatt@peterkatt.com