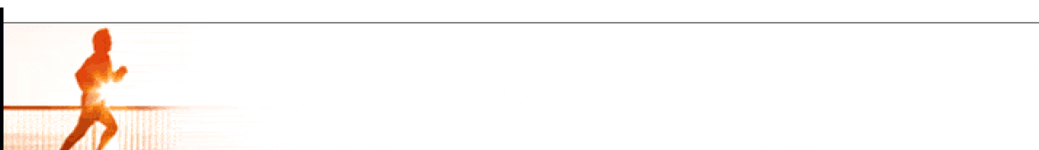

History of Cash Value Life Insurance and Implications for Existing Policies

by Peter C. Katt, CFP®, LIC

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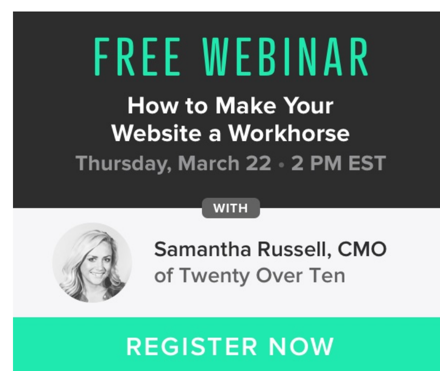
Cash value life insurance has an interesting history. In this column, I provide some highlights with a summary of my thoughts on how to handle these various policy types today.

1977–1992

About 1977 marks the period that national high interest rates started showing up in participating whole life (PWL) dividend values and when mutual companies started providing a "dividend interest rate" figure. Prior to about 1977, companies just referred to it as the "1975 scale," for example. The primary insurance products sold until the early 1980s were PWL policies sold by the mutual companies, and whole life policies sold by stock companies. PWL's premiums were higher than whole life, but they'd be enhanced by future dividends. Conversely, the whole life story was for buyers to side-fund the difference and it would exceed the future value of dividends. For the first time, spreadsheets were prepared by agents to show this.

By 1979 interest rates were so high, pulling dividends with them, that whole life (with no dividends) came out with new policy series every few months to appear competitive. This signaled the death of whole life. I rarely see whole life policies still in force. PWL has provided superior policy value, with Northwestern Mutual and Guardian to be especially admired for giving the same treatment via dividends to all policies no matter when purchased.

Early in the 1980s, universal life (UL) was introduced, offering buyers double-digit interest crediting rates (new money rates) that were higher than PWL's portfolio rates. Agents used these illustrated higher rates to replace as much PWL as they could. Most (if not all) of these first-generation ULs have a policy maturity age of 95. This presents a serious problem today, because those age 90-plus are a fast-growing demographic; insureds are outliving their policies.



ULs purchased throughout the 1980s and 1990s are uniformly underfunded, and today, are in great risk of terminating well before insureds' life expectancies because they were sold with much higher crediting rates that have all fallen dramatically. And, no one has reviewed the policies to adjust the premiums higher to maintain solvency. This is a huge problem.

1993–2003

1993 marks the year when PWL dividends and UL crediting rates began to gradually decline as lower interest rates dug in. During the era of historically high interest rates, mutual insurance companies began to promote their PWLs with vanishing premiums. With high dividends and computing power in every agent's office, illustrations could be presented showing a limited number of years to pay premiums, then the policy would become self-sustaining. This vanishing point was often 10 years or less.

Companies were vying to show the fewest number of payment years before the policy was self-sustaining, and some of them started using actuarial steroids to out-perform their competitors. Regulations were enacted to hold this in check, but I'd argue it hasn't been particularly successful. Dividends then started their decline, and the number of years for payments increased. The mutual companies faced class action suits and all but a couple settled.

With dividends declining, many agents turned to variable universal life (VUL) that has various stock and bond subaccounts from which the policy owner can choose for investing their premiums/cash values. This allowed agents to illustrate investment returns of up to 16 percent (it is now lower). With this kind of compound interest firepower, many PWLs and ULs were replaced by VULs. However, VULs are toxic insurance assets because of extreme investment volatility that destroys policy owner confidence when the inevitable investment crashes occur. VULs need reviewing and management if a policy owner decides to continue with it (see www.peterkatt.com for my many columns on VULs).

2004–Present

In reaction to being burned by promising vanishing premiums at a time of historically high dividends and interest crediting that significantly declined, many insurance companies designed a new policy type, guaranteed universal life, or ULG. With these policies, premiums and death benefits would no longer be subject to future interest rates. The most aggressive companies offered eye-popping premiums that they then had to drop on subsequent policy iterations in order to make sales. The excellent guarantees were possible because ULGs have low to zero cash values. Therefore, when a policy lapses because premiums have been missed, the policy owner does not receive the policy's asset share (typically the cash value in PWL), so ULG companies make a profit that benefits persisting policies and has made the low pricing possible. So far, these companies have remained solvent.

Around 2009, another new policy type became popular, indexed universal life (IUL), which promises that its interest crediting rates are determined by reference to the S&P 500 stock index with no losses. I have seen illustrated rates as high as 9 percent that also included a 0.5 percent bonus rate starting in the 11th policy year for illustration purposes.

The problem is that IUL premiums are not being invested in the S&P 500 by the selling companies. Something on the order of 95 percent of their investments are fixed-income instruments. They claim they can make up the difference by using various hedging techniques to cover promised IUL crediting that are much larger than their investment portfolios produce. Even if companies have actually designed hedging formulas, such exotic strategies are notoriously inaccurate. It is a mystery to me how IUL isn't in violation of

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I think it's likely that IUL will turn out to be a marketing gimmick using stock returns to justify illustrating much higher interest crediting rates than a company's investments can possibly attain. Sales pitches using 8 and 9 percent crediting are 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 12-month period and will communicate it to you in an annual report or in notices to you." In my opinion, this means the insurance company can credit whatever they want. The potential problem for buyers is raised expectations of policy performance measured either by lower premiums or higher cash values than would otherwise be expected.

To Sum Up

Participating whole life (PWL): almost all are an excellent value. The most important issue is handling loans. This can be dealt with—depending on the amount—by continuing the loan, restructuring the policy to reduce or eliminate it, or by paying the loan back. Another issue is not paying the contract premiums (instead using dividends to pay them). When cash flow permits, it is almost always a wise move to pay all premiums because the returns on such payments, measured against either cash values or death benefits, are excellent.

Whole life (WL): as noted, very few of these are still around. For those that are, they are generally holding up because of our current 3 percent interest rate era.

Universal life (UL): I imagine 95 percent or more of these policies are underfunded. This and policy maturity need to be looked at closely.

Variable universal life (VUL): should be reviewed; policy owners may decide to move cash values to the VUL fixed account to avoid future investment crashes, replace with either PWL or ULG, or manage their VUL continuing the subaccounts as strictly an investment.

Guaranteed universal life (ULG): no review needed; no moving parts. Because there are low to zero cash values, there's really no option to do something different.

Indexed universal life (IUL): should be reviewed to adjust policy owner expectations about premiums and/or cash values. A reduction from sales illustrations at about 8.5 percent to 4 percent may provide a realistic view of an IUL's future with a possible significant increase in premiums.

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