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Secondary Guarantees in UL: Commoditize at Your Peril

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Universal life burst on the scene just before 1980 amidst denial and outrage, by some, over what was then revolutionary pricing and design; but welcomed with glee by others as a highly differentiated permanent life product. Those of us who embraced the new product became proficient with a new vocabulary not previously used in life insurance, including such expressions as account value, COI, interest assumption and mid-point illustration.

In order to allow an audience of life insurance professionals to understand universal life, a bucket or funnel illustration was typically used, with gross premiums pouring into the account value bucket and COIs and expense loadings trickling out. Inside the bucket, the power of compound interest did its magic, allowing the interest assumption to be the primary performance driver in universal life.

The early days of universal were the heady days of current crediting rates of 10 percent or more. The guaranteed side of the illustration might show a plan self destructing (or, zeroing out—another new vocabulary expression) long before maturity or even life expectancy, but guarantees, comprised of guaranteed mortality and guaranteed interest rates, represented such a doomsday scenario that they were largely dismissed in that era of double digit interest rates.

The new reality of the 1990s included a decade of inexorably declining interest rates. Suddenly those zeros in the guaranteed column got some attention. Insurers responded with threshold premiums providing longer and longer guarantees, and the concept of secondary guarantees emerged. Secondary guarantees allow a guarantee support mechanism independent of a policy's account or cash surrender value. As secondary guarantee pricing strategies evolved into this decade, and demand for them grew, they became the dominant permanent product offered in the independent distribution channels. The emergence of secondary guarantees in universal life pricing has introduced yet another round of new vocabulary, this time with expressions such as shadow account and catch up. Unlike the marketing around universal life as a new pricing concept, the marketing of secondary guarantees has taken on a commodity look and feel. Focus seems to be on "lifetime guaranteed premium" with spreadsheeting activities emphasizing the less expensive product, irrespective of shadow account assumptions, an analysis of the cost of catching up and other pricing or policy behavior. A commodity approach to secondary guarantee supported universal life is highly perilous for practitioners in this business.

Universal life was once billed as "the only life insurance policy you'll ever need" due to its flexibility. Death benefits can be adjusted up or down, premiums can be altered or even skipped, and the notion of separating and identifying the mortality, expense, and interest components in a permanent life premium, renders the "fixed" nature of premiums almost meaningless. Secondary guarantees change all of that—so much so that putting secondary guarantees on a universal life chassis is virtually a conflict in design. Secondary guarantees take the form of either a cumulative premium structure or a shadow account structure. Both can provide absolute guarantees relative to premium adequacy and death benefit, but both can become compromised with adjusted death benefits or altered or skipped premiums. Secondary guarantees are only preserved if the premium payor follows premium payment directions explicitly. Any variation from the amount and timing of premium payment illustrated can jeopardize the guarantees. Even rather benign lax behavior on the part of the payor—chronic three or four week delays beyond the premium due date (but still within the grace period), for example—can trigger a need to utilize the catch up provision and, failing so, risk lapsing a contract sold as "guaranteed."

Secondary guarantee supported universal life is now being billed as "guaranteed cost, guaranteed death benefit permanent life insurance." That billing is only accurate if the policy owner fully complies with what is expected of him; and those expectations are rarely clear upon reading policy language or accompanying documents. Ironically, a relatively simple policy form that spawned countless seminars to help life insurance professionals understand it at its introduction in the early 1980's is now a hopelessly complex product fraught with numerous points of potential conflict, and today's version is largely marketed as a non-differentiated commodity. That, my friends, is a problem waiting to happen.

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Prior to founding LPI, Greis spent 12 years in underwriting and marketing capacities at the home offices of major life insurance companies and 20 years as a Brokerage General Agent. He entered the brokerage business in 1981. Greis holds memberships in Risk Appraisal Forum, an underwriting study group, and LIFE, Inc., a marketing study group. He is a past chairman of NAILBA and is a frequent author and speaker on industry affairs. He can be reached via e-mail at chris@leaderspartners.com.