

Understanding VUL Policies

Hypothetical projections used to sell them are misleading. Here's why.

By Joseph W. Maczuga



Illustrations are the basic selling tool of the insurance industry for variable universal life (VUL) products. Unfortunately, clients and most advisors do not understand—or discuss—the many misleading components that are instrumental in the creation and design of these hypothetical projections.

The Concept

Under pressure from consumers in the 1970s with the “buy term and invest the difference” revolution, industry analysts concluded they had to create a product that would provide an option to fixed-premium whole-life policies. The cost assumptions for those policies were based on old, expensive mortality tables with minimum interest-rate assumptions. If a policy could provide “current” mortality charges and “current” market-rate returns, clients would be enticed to purchase such a policy. They also would have the benefit of a tax-advantaged umbrella protecting the cash-value asset, which was not available for the investment side of the term-invest equation.

If the “current” costs and returns would change

from year to year, the new policy format would have to be flexible. The contract should allow the insured the advantage of paying current costs to keep the policy coverage in force, as opposed to paying a fixed premium. Thus, the insured could deposit premiums within a given range, allowing for such deposits to vary from time to time at the insured's option.

Whenever it was needed, a change in coverage could be made by just changing the face page of the policy. Another innovation could be that all charges and market-crediting activity would take place on a monthly basis. In addition, the policyholder could access the cash value through two methods: withdrawal or loan, as opposed to “loan only” for whole life.

VUL policies fit the bill. It could provide clients with total flexibility in cost, return, premium deposits and coverage. The concept was absolutely dynamite and provided what the consumer wanted—in theory.

Gross Return And Net Return

One interesting aspect to VUL illustrations is that there is no guiding authority on what cost elements of the policy need to be subtracted from the assumed gross return to determine the assumed net return. One might believe that an illustration with a higher assumed net return is a better, more cost-efficient policy. This is not necessarily so.

Full disclosure is not required, so the entire illustration needs to be searched to find what cost elements were used. The exception is a low-load illustration, which fully discloses costs and states that the assumed gross return is reduced by three expenses: mortality and expense (M&E) charges, administration charges and fund management expenses. For one prominent low-load VUL policy, for example, these expenses may total 1.47%.

With other illustrations, generally only fund management expenses are used to reduce the assumed gross return. On occasion, you may find that two cost factors have been integrated into the equation. In these instances, the cost elements that are not considered have not been removed; they just have been placed on the other side of the assumed net return and hidden in the

illustration software (Black Box), placing the responsibility on the planner to locate and interpolate them.

There are two inherent problems with this scenario. First, a subtle illusion is designed to give the *impression* that the higher assumed net return reflects a more efficient policy. Second, as we all know, capital that compounds *before* cost reduction will accumulate higher projected values than capital that compounds *after* cost reduction.

Projected Rate Of Return

This part of the illustration is the most misleading. Even though every illustration has disclaimers stating that all figures are hypothetical assumptions, there are no guarantees, and all things are subject to change, the client thinks in terms that the agent or planner uses in discussing the illustrated product.

These thought processes also would relate to mutual fund concepts because many of the money managers are familiar industry names. We know very well that market volatility is going to vary performance in any given year. That is acceptable. We also know that mutual fund historical performance of 3-, 5-, and 10-year returns may tell us something about the money managers by their average annual return. We also agree that past performance is no guarantee of future results, and that is also acceptable. However, although our mindset may be in the mutual fund universe, VUL is not a mutual fund. It is an insurance policy with certain costs and investment selections.

Does the financial industry allow you to illustrate projected hypothetical values of any specific mutual fund? No! Do mutual funds have heavy surrender charges over the first 10, 12 or 15 years that limit your liquidity, flexibility and control? No!

Most important, there is a difference between an average rate of return and a static rate of return. The Rule of 72 states that, at 12% a year, money will double in 6 years. But if you interpolate market performance over six-year periods that averaged 12%, it usually took more than six years to double. The truth is that the illustration is projecting a hypothetical static return of 12% (or whatever assumed gross rate is selected). Even if the desired average is achieved, the illustrated project-

ed values are baseless.

Assumed Rate of Return

This illustrated column is mandated but only serves to validate the uselessness of the illustration because it assumes that the market will never have a negative year. Anyone who believes that should not be in an investment product.



Costs

The flip side to the assumed rate of return quotient of the illustration is the “costs” associated with the policy. After all, the only thing the illustration develops is an assumed hypothetical based on two factors: rate of return and policy costs. What are these costs? Clients and advisors have no idea because the costs are bundled and hidden in the illustration software and are not fully disclosed (with the exception of a low-load product, which has a full disclosure page). Even with partial disclosure, there is no explanation of the basis used in developing the components of those costs shown.

We do know that there are “maximum charges” and “current charges”—and that there is quite a spread between the two. We also know by the disclaimers on the illustration that all of these components of “cost” are subject to change (there are about eight components) and the “changing” of any component is at the company’s discretion. The tweaking of any of these cost elements can illustrate better future values, but there is no substance to support those future values.

What Does “Variable” Mean?

Although the term “variable” is accepted as the style of policy discussed, the proposal presentation, illustration format and omission of function seem to contradict the term. If everything is “variable,” any computation of future values has no basis. This is especially true when developing a “level premium” to endow or to achieve a future stated cash-value objective. Such inter-

polation is impossible. The figure developed isn’t any more accurate than one you could pull out of the air.

In fact, in a well-researched article, authors Richard Weber, MBA, CLU; Christopher Hause, FSA; and Robert Littell, CLU, ChFC, developed a program (HVM) that takes the average weighted policy costs of the top-selling VUL companies to determine a level premium to endow. When integrating 300 various simulations of historical market performance, they found that the level premium had about a 50% probability of success in achieving its illustrated objective. If this is the case when analyzing the “return” quotient of the illustration, how much additional impact will there be when the “cost” side of the equation is analyzed?

The only elements of the policy that are not variable are those of the commission structure and surrender period.

Compensation

Because loads and commissions may make up as much as 150% to 230% of the first-year premium dollars, insurance companies have to protect their high upfront outlay by attaching heavy surrender charges to the equity (cash value) element of the policy to amortize their liability of policy acquisition. Since every economic element in the policy (cost and return) is subject to change at any given time, and if there is no, or very little, liquidity to the policy, what real gains has the client obtained? If today’s rate of return is high but unavailable, isn’t it possible that tomorrow’s increased costs could eat it away? Account value represents funny money since it has no liquidity value to the client until all surrender charges disappear. For example, if your investment portfolio or mutual funds were worth \$100,000 at the end of 1999, but you did not liquidate and now they are worth \$75,000, what benefit did you derive from the additional \$25,000 you had on paper in 1999?

If we dissect and compare a commission-based VUL with a low-load VUL (where the planner or advisor is compensated by a fee), we can see how theory can flourish. Since the low-load policy removes the bulk of the loads and all of the hierarchy commissions from the policy, the client can, in fact, obtain the advan-

tages of the VUL concept. Premiums are unbundled so that current costs are fully disclosed and purchased. Current rates of return are paid and accumulated in cash-value equity, which is fully liquid and unencumbered by surrender charges. The client has an expanded range in premium flexibility, and maximum liquidity in the first year allows greater control. To have full flexibility and control, you must have full liquidity. This is pure functionality in line with the V.U.L. concept.

An opposing argument grants that projected returns are static instead of variable, but if both illustrations use the same net static rate, then the one with higher values in later years has a better cost basis since projected returns are the same in each case.

VUL account value represents funny money because it has no liquidity value to the client until all surrender charges disappear.

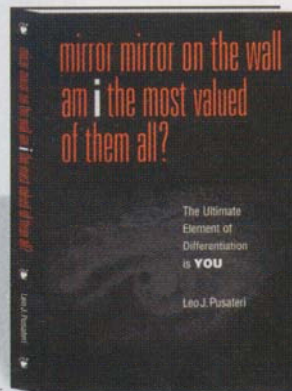
That may seem like a logical conclusion if we ignored the multiplicity of those cost development factors, as well as nonguaranteed bonuses. One example would be a lapsed-based premium structure. It may look very competitive, but if historic persistency varies (which it would), rates will have to be increased dramatically to cover the shortfall to the company. AND, the illustration doesn't state, nor is it required to state, that the premiums were developed under such a scenario.

Conclusion

Due to these realities, any analysis of illustrated product comparisons based on future cash values or level-premium scenarios is without basis or value. Only the first year has any significance for analytical objectives. ☉

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