Guesses, Projections, Promises and Guarantees

by Lawrence J. Rybka, JD, CFP®
R. Marshall Jones, JD, CLU, ChFC, AEP

Abstract: *Universal life policies with secondary guarantees have become an unequalled marketing success, especially for the wealth transfer market. With their low guaranteed premiums, they are the automatic life insurance recommendation for many insurance agents. However, the very success of secondary guarantees is creating growing concerns both for the insurance industry and the public it serves. Recent special reports by Moody's and Fitch regarding pricing adequacy and emerging liabilities have amplified the importance of addressing this challenging topic. This article takes an in-depth look at secondary guarantees, including their long-term financial impact, the alternatives, and the importance of due care. It is relevant to insurance professionals, trustees, advisers, policyholders, and insurance companies.*

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Secondary guarantees have presently become the U.S. life insurance industry's most popular products for the wealth transfer market, their stronghold fortified by the prima facie attractiveness of guaranteed premiums that are as much as 55-60% below comparable whole life premiums.[1] The obvious ease of marketing these products has caused many insurance agents to make secondary guarantee products their automatic recommendation to all clients needing death-benefit-oriented life insurance.

While secondary guarantees constitute an unequaled marketing success, they have triggered growing concerns among the industry's leading pricing actuaries and rating agencies. They caution that some companies having large blocks of secondary guarantee products may, in some circumstances, cause long-term financial impairment to their reserves and create risk for those very policyholders who were seeking the safety of guarantees.

The purpose of this article is to examine the long-term financial impact of secondary guarantees and address the importance of exercising due care in their recommendation to clients.

Viewing the Big Picture

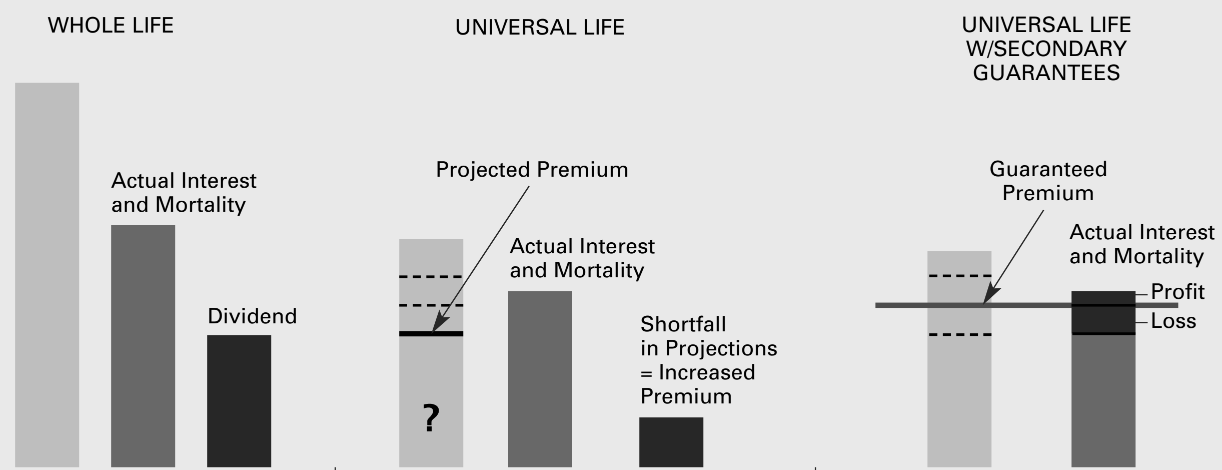
To examine this situation from a larger perspective, secondary guarantees represent the most recent turn of events in the evolution of life insurance products. For almost a century, whole life was the only type of permanent life insurance in the United States and was built on the premise that the consumer pays a high guaranteed premium relative to the policy's death benefit. Premiums were based on conservative assumptions that were fully reserved for in a manner dictated by state insurance commissioners. Life insurance reserves for general account products were and still are required to be invested mainly in conservative bonds, mortgages and fixed government instruments. Annually, at the company's discretion, a portion of the reserves' surplus was credited back to policyholders in the form of dividends. These dividends, which were historically higher than projected, could in turn be used to offset the policy's premium and reduce the policyholder's outlay (Figure 1).

In the early 1980s, the advent of personal computers and high current interest rates prompted companies such as E.F. Hutton Life and Executive Life to pioneer the development of a new product: universal life. In this policy format, the policyholder gave up the certainty of a guaranteed premium in exchange for a lower current outlay. This product format also gave the policyholder much more flexibility in paying premiums than whole life. Computer illustrations allowed the consumer to use 1980's double-digit interest rates to lower the planned premium on a projected basis.

In reality, the insurance companies were not guaranteeing anything more than they were with whole life. They merely repackaged their guarantees to allow this flexibility by applying the same conservative interest and mortality assumptions used for reserving. In exchange for a lower outlay and premium flexibility, the universal life format transferred the premium sufficiency risk to the policyholder. If the interest crediting rate dropped, or if the insurance company needed more money to cover increased mortality costs or provide more profit, then more premiums would be due, and if not paid, the pol-

FIGURE 1

Evolution of General Account Products in U.S.



High guaranteed premium based on conservative interest rates and mortality. Positive experience rebated at company's discretion via dividends.

Consumer selects premium based on projection of cost factors and long-term interest rates. Company credits policyholder at its discretion. Above-minimum interest rates and mortality shortfall results in need for more premium than originally projected.

Company uses standard UL type chassis and makes secondary guarantee that if consumer pays a certain premium, it cannot be increased by company.

icy would eventually terminate without value when the policy capital was used up by the increased costs.

However, this was a risk that was seldom explained by insurance agents and rarely understood by policyholders. Many policyholders and trustees perceived the quoted premiums as a promise. In defense of the insurance industry, few insurance professionals at that time could have foreseen that crediting rates would drop 1,000 basis points in the not-too-distant future. The policy flexibility of universal life also led many policyholders to pay even less than the initially scheduled premium. For these reasons, universal life, as a product type, has created a legacy of disappointment and broken promises for policyholders and advisers alike.[2] As interest rates dropped lower and approached levels that were guaranteed in the contract, companies recognized that without intervention, universal life would completely fall out of favor as a viable form of insurance.

Enter Universal Life with Secondary Guarantees

In 1985, Security Connecticut (now owned by ING) pioneered an innovation in universal life that provided a "secondary guarantee." That guarantee stipulated that if the stated premium was paid, the policy would not lapse even if the company changed underlying assumptions and the policy ran out of cash value. It was coined a "secondary guarantee" because the premium guarantee was not reflected in the reserves or nonforfeiture values (cash value). This innovation addressed one of the biggest disadvantages of universal life by putting a cap on the amount of premium the policyholder would have to pay. The first generation of these products provided guaranteed coverage for a certain period such as 20 or 30 years. More recent versions are guaranteeing coverage for life as long as the contractual requirements are met.

From a consumer's point of view, this innovation was the equivalent of a "term-to-100" contract. However, from a state regulatory perspective, these products were taking advantage of loopholes in reserving requirements that require financial reserves to be set up to back long-term contractual promises.

In the last 10 years, this type of contract has gone from a niche product feature with one vendor to a primary feature that is viewed by many agents as mandatory to compete for universal life market share. From a consumer's perspective, it is easy to understand and creates certainty for future premium payments. From the producers' point of view, it allows them to create clear expectations in the minds of prospects. It further allows them to replace existing universal life products in situations where projected premiums have ballooned due to falling interest rates. For some companies, it has provided a sales bonanza of increased sales and short-term profits. For all, it has fundamentally altered the game by requiring carriers to provide increasingly lower guaranteed premiums to attract sales in an increasingly competitive price-driven environment.

So What Is the Controversy?

In a recent copy of *The Insurance Forum,* Joe Belth was one of the first to publicly address an issue that has been hotly contested behind the scenes by actuaries and regulators. He warned his readers that "the whole purpose of insurance regulation is to keep companies from charging too little." At the same time, he pointed out that "powerful market forces keep them from charging too much."[3] Pointing to the lessons of history, he noted that it was exactly this kind of intense price competition by insurance companies in the late 19th century that led to the near collapse of the insurance industry. The very reserving requirements that came out of the Armstrong Commission (the commission charged with reforming the industry to prevent catastrophic failures) are the ones being challenged today through creative reserving of shadow accounts for products with secondary guarantees.

There has been an ongoing attempt by the National Association of Insurance Commissioners (NAIC) to force companies to reserve for these long-term premium guarantees. Each attempt to limit aggressive pricing has resulted in a new "innovation" by these companies that appears to sidestep the revised reserving rules. In 2000, Actuarial Guidelines XXX impacted not only term insurance reserves but also some early generations of secondary guarantee universal life by requiring companies to increase reserves on long-term premium guarantees.

However, it didn't take creative actuaries long to find a new way to provide these low premiums within the confines of XXX. They did so with "shadow account" products. Under this type of product design, the company posts additional reserves "as needed" to meet promises on a rolling basis. By measuring current results versus projected results in the shadow account, this type of valuation allows companies to delay reserving and gives them large latitude in determining what was expected versus what is actually being experienced in their block of business (Figure 2).

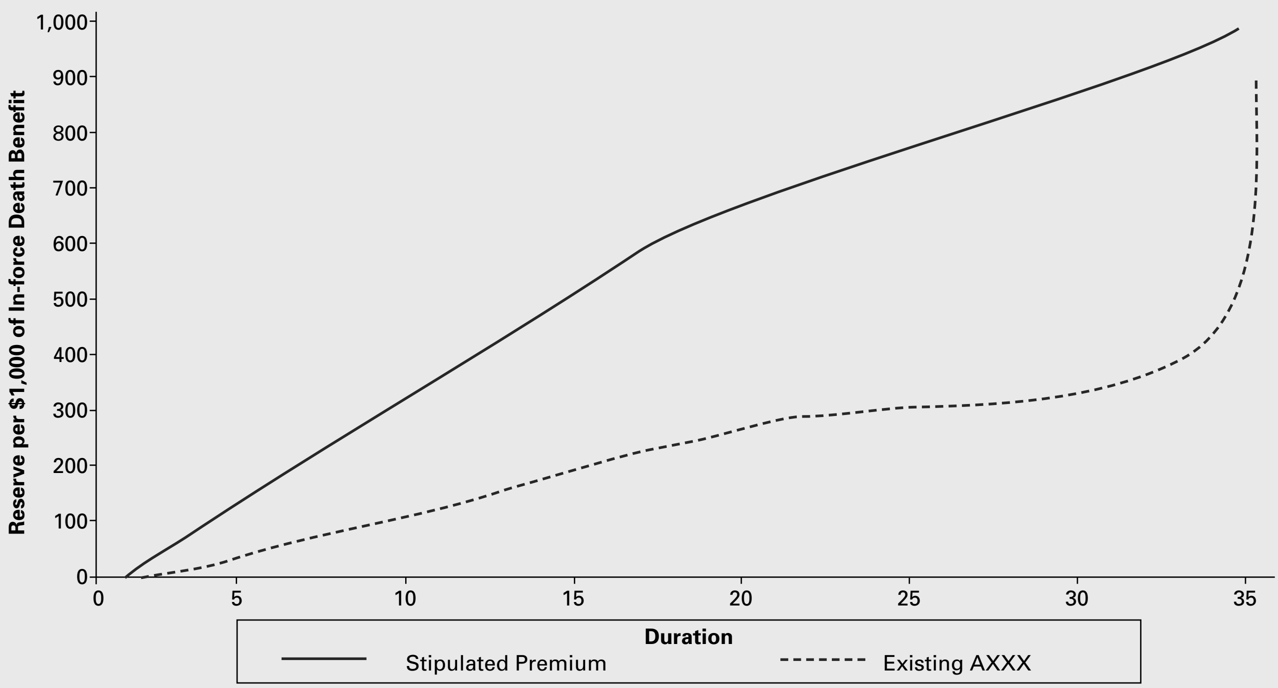
Industry analysts viewed this vague standard of reserving to be no standard at all. The NAIC responded in 2003 with Actuarial Guideline XXXVIII titled, "The Application of the Valuation of Life Insurance Polices Model Regulation," otherwise known as "AG38" in actuarial circles. In response, companies once again changed their products slightly, many lowering premiums further.

If critics find this behavior questionable, companies are quick to defend their practices with opinions from their actuarial staff that company reserves are adequate for their secondary guarantee products. To prove or disprove these declarations would be difficult, especially without actuarial access to their proprietary pricing models.

Independent actuarial experts caution that the 2003 regulations still give companies wide latitude in how and when they reserve for secondary guarantees. The basic economics of secondary guarantee products, along with the arguably deficient amount of reserves held, suggest that the risks involved are significant and there may very likely be a "day of reckoning" coming for these products. Because of the normally slow buildup of reserves, that day of reckoning may be 10, 12 or 15 years from now. In Fitch's July 2004 Special Report, Jeff Mohrenweiser, FSA, CFA, projected that this day of

FIGURE 2

Formulaic AXXX Reserves, Issue Age 65, Creative Shadow Account Design
Male Preferred Nonsmoker, Level Annual Premium of $18.02 per $1,000



Source: Scott L. Berlin, New York Life Insurance Company reckoning will require the U.S. life insurance industry to have a capital infusion of between $50 billion and $100 billion to back existing blocks of secondary guarantees.[4] He predicted that this capital requirement will force a consolidation of those who are able to sustain this business to a handful of the best-capitalized carriers.

A Matter of Common Sense

Substantiating the adequacy of shadow account reserving under AG38 would likely require a degree of math aptitude not possessed by 95% of those selling secondary guarantee insurance nor by 99.9% of those buying it.

A recent client who was considering purchasing a secondary guarantee policy looked at the proposed transaction from the insurance company's perspective and asked, "How does the company make money if I pay $29,000 for $1 million of death benefit?" This very savvy 75-year-old woman had legitimate reasons for questioning the basic economics of a transaction that did not seem to make sense.

Using her case as an example, a simple internal rate-of-return calculation on the premium-to-death benefit ratio (assuming that she lived to the average insured's age of 90) would require the insurance company to earn 10% with no expenses. Stated another way, if a company is constrained by the actual investment returns of 5% (historical rate for investment quality bonds and mortgages in the general account), the average policyholder would have to live to age 95 or drop his or her policy during his or her lifetime in order for the policy to be profitable to the insurance company (Figure 3).

Lapses: The X Factor

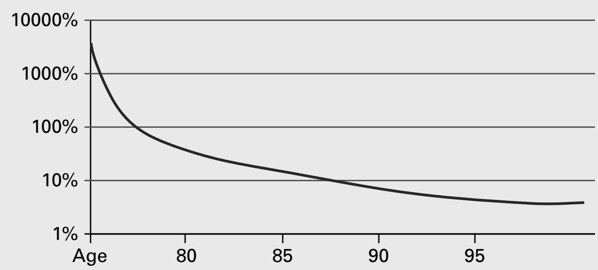
How can an insurance company that is required to invest in high quality intermediate bonds and mortgages carry products that seem to produce internal rates of return this high at normal life expectancies? In these secondary guarantee designs, companies assume that many policyholders will not keep their policies until death. With secondary guarantee products, the lapsing policyholder receives very little in the way of cash value. The theory is that the insurance companies can use the money of those who cancel to support those who stay. However, small differences in lapse assumptions make big differences in the number of contracts that will require payment of a death benefit (Figure 4). Both Moody's and Fitch emphasized in their July 2004 reports that lower-than-expected long-term lapse rates would be a disaster for no-lapse carriers.[5]

Secondary Markets

An additional wild card in the pricing game is the development of secondary markets for these policies. Under this arrangement, investors buy polices from the unhealthiest policyholders and give them more cash than they would have received from surrendering the contract.[6] The secondary market for life insurance policies is exploding and is estimated to grow substantially in the next several years.[7] As long as the true market value of a policy is higher than the cash surrender value, the market will persist and continue to expand. The most attractive type of product for this secondary market is the policy with secondary guarantees because it allows the investors to capture the values from policies that have lapsed. It was precisely this development in the secondary market in Canada that caused Great West Life to lose substantial amounts of money on its term-to-100 product that was subsequently pulled in the early 1990s. One senior pricing actuary commented, "The expanding settlement market changes the rules of the game. It's like a game of musical chairs where, all of a sudden, someone substitutes a player piano and the players have to keep walking."[8]

FIGURE 3

Guaranteed Death Benefit IRR
Female, 75, Nonsmoker Preferred Plus



The Effect on Mortality Results

The risk of lower-than-expected lapses also has an effect on mortality results for life insurers. Moody's and Fitch explained that a combination of mispricing factors produces a "multiplicative"—not additive—effect on profits. The life settlement market will ensure that the policies with the worst mortality experience will persist to a greater degree than ordinary policies. The upshot is that carriers will experience worse mortality results and longer persistency than they anticipate.

Evidence of this is emerging in a new and very controversial financial transaction known as IOLI (investor-owned life insurance). Under this arrangement, there is intent to buy large amounts of insurance on older clients and have a prearranged agreement with outside funders to purchase policies solely for resale in the secondary market. The lenders actually underwrite and price the life settlement based on the insured's current health and the carrier's sales ledger.

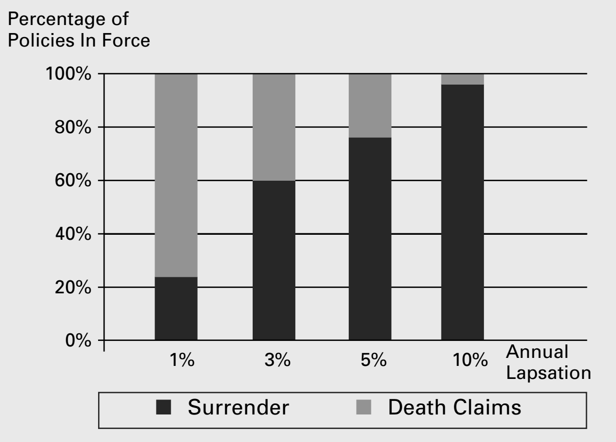
So What if the Product Is Mispriced?

Why the concern? Isn't this the insurance company's problem? Too much of a good deal could ultimately harm not only the companies with secondary guarantee products but the policyholders as well.

Both whole life and early generations of universal life without these guarantees created little financial risk for the companies that issued them. The gaps between guaranteed mortality and guaranteed interest rates always left sufficient spread to assure profitability. With these traditional products, dividends or excess interest were nonguaranteed projections that did not impact insurance company long-term income statements or balance sheets.

FIGURE 4

Pricing for Surrender vs. Death
40-Year Life Expectancy



However, secondary guarantee products represent a new game where a fixed promise is made to policyholders. By giving the consumer a guaranteed price for the next 30, 40, 50 or even 60 years, carriers are taking a significantly greater financial risk. They would be wise to heed a lesson from the not-so-distant past. For example, the fixed pricing on a relatively small block of non-cancelable, guaranteed renewable disability coverage written in the 1980s caused hundreds of millions of dollars in losses and reduced the field of remaining carriers by a third. Misprojections on interest rates, lapse assumptions, mortality, and expenses over extended time periods cannot be passed on to policyholders. They now directly impact a company's bottom line.

When I presented these long-term pricing concerns to one of our broker-dealer's most successful insurance professionals, he responded by asking me, "Why is there a problem?" He saw these companies' inability to "change the deal" with these products as a completely positive development for his policyholders. He said, "If my job is to represent the client, why should I care if insurance companies may be charging too little for their products?" He then asked me, "Does Derek Jeter or his agent care if the Yankees pay him too much?" I replied that the only reason Derek Jeter might care if his contract was too generous was if there was a possibility that by paying everyone too much, his checks would bounce. This is exactly the risk that must be quantified and addressed with secondary guarantee products.

Secondary Guarantee Policyholders' Risk in Insolvency

A largely unaddressed question is what would happen to policyholders with secondary guarantee products in the event of a company insolvency? While the policyholder has bargained for a low guaranteed premium, companies have, by and large, designed products with very little cash value, hoping to use money from the policyholders who cancel to pay claims on those who persist.

Given this scenario, what would happen to a policyholder who purchased a policy at age 75 if the company fails 15 years into the contract? What would this 90-year-old policyholder receive from a rehabilitator or state guarantee fund?

The insufficiency of reserves and their nonforfeiture values in this type of product creates the ultimate downside risk: loss of the guaranteed premium policy and little or no cash value. With secondary guarantee products, the policyholder is completely dependent on the continuation of the promised premium guarantee.

It is important to note that most state guarantee associations only guarantee limited death benefits and cash value on a limited value. These guaranteed funds generally make no provision for the continuation of premium guarantees. For example, we can look to the actual experience of policyholders in the Executive Life, Mutual Benefit and Confederation Life rehabilitations. In all three circumstances, the rehabilitator had the right (and exercised that right) to reform contracts for the equitable benefit of all policyholders. In all three of these multi-billion-dollar failures, contracts were changed to fairly distribute the shortfall between assets and liabilities.

Therefore, in the event of insolvency, it is likely that the premium guarantee would not be honored by a rehabilitator, especially for policies with an excess of $300,000 of death benefit (the maximum amount provided by most states' guarantee funds). A full appreciation of this risk should make trustees and policyholders aware that the consequences of a company failure with this product type would be far more severe than those experienced in any previous failure involving whole life or early generations of universal life. The absence of sufficient reserves and their accompanying cash values means that the policyholder is even more reliant on the financial health of the carrier to meet its promise of a guaranteed premium.

How Big a Risk?

That brings us to the central issue and the purpose of this article: to examine if there is a possibility that secondary guarantees may present a substantial risk to some insurance companies and their policyholders. The short answer is that the experts disagree. Ever since secondary guarantee products came on the market, there has been an ongoing controversy as to what reserves should be set aside to meet the long-term promises made by companies in these contracts. The absence of agreement is largely due to the fact that reserving involves predicting the economic factors that will impact these policies over their lifetime. Any long-term projection of this type is fraught with peril. Thus, the remainder of this article will examine how rating agencies, insurance carriers, policyholders, trustees, and life insurance advisers should view this product. Of ultimate importance will be the subsequent advice that objective life insurance professionals give to their clients and trustees.

The Rating Agencies

It is important to be reminded that the main function of the rating agency is to give an opinion on the long-term financial strength of carriers. They make no judgment about quality or competitiveness of the company's products. Rather, they are more likely to give higher ratings to companies that have a high profit product with the smallest risk to the company.

It is important to remember that most of the major problems that ultimately resulted in the failures of insurance companies were not on the radar screen at these agencies until one or more companies went into receivership due to these "newly discovered" risks. It was only then that the rating agencies sounded the alarm bells regarding

- junk bonds (Executive Life)
- heavy concentration of commercial real estate (Confederation Life and Mutual Benefit)
- mismatching duration of investments and issued financial instruments (Equitable and General American)
- reinsurance risk on death benefits of annuities (American Scandia)

Up until the summer of 2004, the issue of secondary guarantees was not prominently discussed in any company's published ratings. According to officers at companies that recently underwent rating reviews, secondary guarantee business was not acknowledged by rating agencies as a distinct block of business with a different pricing risk. These agencies may have wrongly assumed that there are no significant risk differences between whole life, early generations of universal life, and the most recent versions of universal life with secondary guarantees. Failure to understand the fundamental difference in secondary guarantee products may have caused them to wrongly assume that these products offer the kind of "cost-plus" pricing that previously allowed companies to have almost guaranteed profits on blocks of whole life and universal life.

However, the rating agencies have begun to shift their viewpoints on the subject. In July 2004, Moody's and Fitch put secondary guarantee carriers on notice that they would evaluate these blocks of business differently. Moody's became the first to identify this class of business as a substantial risk in its July 2004 Special Report.[9] A month later, a warning was issued by Fitch.[10] The chain of events that caused these two agencies to put the issue on their radar screens was a combination of the proposed action by NAIC to close the "very big" loopholes left in AG38 reserving requirements (shadow accounts), a recent tightening of reinsurance rates, and the unfavorable outlooks from several perceptive stock analysts. Both Moody's and Fitch are now officially on record in notifying companies that there is a new and significant factor in their evaluation of long-term financial strength. Companies with large blocks of aggressively priced secondary guarantee and term products should expect to see downgrades in their ratings unless they are able to show the additional capital needed to back these promises.

However, even the biggest detractors of secondary guarantee products cannot say with certainty that these products *will* be underpriced. Moody's July 2004 report states, "Moody's fears that insurers writing these policies *could* suffer large losses if aggressive pricing assumptions involving portfolio yield, surrender rates, letters of credit costs and mortality do not materialize *as expected.*" While companies may dismiss this combination of factors as unlikely, they are forced to admit that the factors that will determine the long-term financial impact of this outcome are out of the control of the companies once the product is issued. The future of interest rates, reinsurance rates, mortality, adverse selection, and, most importantly, lapse assumptions are macroeconomic assumptions that may impact the entire industry, not just one company. The companies selling secondary guarantees have actuarial models that show the products being profitable. But, if the assumptions are changed, even slightly, the profitability results can swing dramatically downward.

For example, a combination of low interest rates, low lapses and overly aggressive underwriting would create a "perfect storm" that has the power to not only impair ratings and profitability but also to actually take down major carriers without the capital base to sustain such a storm. In the event that companies making optimistic guesses about these important factors are wrong, they will be very wrong. Furthermore, this chain of circumstances would likely impact not just a few companies, but all companies that made these bets with large blocks of secondary guarantee business. This potential storm is still far from shore and, absent a major failure that highlights this pricing risk or insurance commissioners demanding reserves, it will likely not surface for at least 10 or 15 years.

The Insurance Companies

Carriers are between a rock and a hard place. Secondary guarantee products are the hot tickets that agents are currently selling and consumers are buying. To attract sales, many companies feel compelled to produce a product, but they must also make certain that the product is consistently priced lower than the products of competitors. As a result, many companies with secondary guarantees continue to lower their premiums to compete in this marketplace. The Internet has only heightened awareness of which companies are most competitive and, as a result, using the most aggressive pricing assumptions.

On the other hand, failure to produce a secondary guarantee product has its own risks. For career companies, it means not only loss of business and declining sales but also the risk that some of their agents may leave to go to companies that are marketing secondary guarantees.

There is an added temptation for some stock companies to market secondary guarantees because of the difference between GAAP accounting and statutory reserving. GAAP accounting (the type reported to the financial markets) allows the company to show early profits on the difference between premium and reserves. Under GAAP and AG38, the long-term "tail" obligations can be pushed off to some distant reporting period and discounted with favorable assumptions.

Because the rating agencies now include this "tail" contingency as a factor in evaluating long-term financial strength, one can anticipate the financial markets to respond, even though short-term earnings may be up. For example, as a result of the recent Moody's and Fitch special reports, news of this pricing risk was subsequently featured in the July 21, 2004, *Wall Street Journal* article, "Life Insurers Face a Profit Squeeze."[11] The strong popularity of these products almost assures that most companies marketing these products will continue their aggressive marketing until rating agencies actually downgrade some of these carriers or regulators step in with clearer reserving requirements.

Product Alternatives

The *Wall Street Journal* reported that the prospect of pushing secondary guarantee premiums even lower to attract business has prompted some companies to seek alternate strategies in product development.[12] One strategy that appears to have initial promise is the updating of separate account products to make them more attractive in the wealth transfer market. In the second quarter of 2004, several market leaders updated their separate account (variable life) chasses by incorporating improved guaranteed premiums. These new hybrid products have assumed several forms and various levels of premium guarantees. In exchange for the guarantees, companies may require the policyholder to give up some of the flexibility in the initial allocations and then adhere to these allocations. By not selling low and buying high, companies protect the policyholder from self-destructive behavior and are able to offer better guarantees. Notable entrants include Hartford, Minnesota Life, Nationwide, and Lincoln National. Both the Lincoln and Hartford designs require a certain amount of cash value to be in the general account in order to receive these guarantees.

This new class of products may be an attractive alternative to secondary guarantee products for four reasons:

1. The ability to invest in equities and their historical return premium over bonds (the holding for general account products) gives the policyholder a realistic prospect that this performance can be used to provide an increasing death benefit or shorten the years to pay premium.
2. The cash value that backs these separate account products is, in most cases, considerably higher than in the current generation of universal life products. This value is not only available if the policy is surrendered, but it also allows increased flexibility in changing the premium or death benefit down the line.
3. The presence of the formal reserve for this value and its allocation to individual policyholders forces discipline in carrier pricing and does not allow companies to make aggressive lapse assumptions.
4. The separate accounts also provide much greater protection to policyholders in the event of carrier insolvency. With this class of products, values belong to the policyholder as separate accounts and are not subject to the claims of insurance company creditors in insolvency or rehabilitation.

Benefits aside, it should be noted that the premium guarantees on these hybrid products are still dependent on a carrier's solvency. Since all of these products only became available in the second quarter of 2004, it is too soon to determine their impact on the marketplace.

Policyholders and Trustees

The attractiveness of a low guaranteed premium for life insurance will always be a primary consideration for those seeking death benefit protection. Clearly, an informed policyholder or trustee would prefer a product that does not allow the insurance company to increase premium over one that does. Informed trustees and policyholders cannot, however, make their purchase decisions based exclusively on the carrier that has the lowest premium while ignoring all other factors. Policyholders must first remember that life insurance products are long-term financial instruments. All policyholders, and especially trustees, should consider the standard required of fiduciaries under the Uniform Prudent Investor Act in their selection of all assets, including life insurance.[13] Reducing the selection criteria to a one-dimensional equation (lowest premium) is the equivalent of a trustee investing 100% of trust assets in a single issuer's long-term bond because it has a slightly higher yield. Taking this analogy further, assume that the low cash value of most secondary guarantee products makes them more like zero coupon bonds that will pay principal in 30 years. The financial risk of a single issuer and the failure to diversify or consider long-term equity premiums are all prima facie grounds for an action by the policy's beneficiaries against the trustee for breach of fiduciary duty. Taking into account all of these factors becomes even more crucial in the selection of trust-owned life insurance, which requires fiduciaries to document the process by which they select any financial product, including life insurance.[14]

Insurance Professionals

Secondary guarantees are here to stay. They will continue to represent a good choice for some policyholders, but they are not the best recommendation for all clients. Any recommendation that does not take into account the client's individual circumstances and investment philosophy would also be inconsistent with the fiduciary standards required of trustees. If life insurance agents are to earnestly serve their clients in an advisory capacity as well as help trustees and other professionals make informed decisions, they must accurately describe the risks and rewards of each product option. They must avoid "selling" a single one-size-fits-all solution or representing one alternative as a riskless solution. They must help clients and trustees understand inherent product trade-offs and guide them to a product solution that is right for their individual circumstances.

Exercising caution regarding secondary guarantee products also creates an opportunity for the best people in the life insurance profession to differentiate their services by:

- Removing their personal bias or doing what is easiest
- Asking hard questions of insurance companies about the concentrations of secondary guarantees in their portfolios
- Considering only companies that have adequate capital to endure potential unfavorable economic trends—Some think this will become easier as the rating agencies factor concentrations of this product relative to capital position into their assessment.
- Examining more closely who is making the guarantee in situations where downstream insurance subsidiaries are actually issuing coverage—Informed trustees should favor contracts issued on the paper of those companies with the strongest balance sheets and the capital to sustain unfavorable experience.
- Considering the impact of a company's secondary guarantee business on its other products—The presence of large blocks of secondary guarantee business may impact the selection of other nonguaranteed insurance products from insurance carriers. If policyholders are relying on the ability of a company to deliver on nonguaranteed elements of its product, a company without a large block of this business may be a better choice. In other words, with all other factors being equal, perhaps it is better to buy annuities, variable life or whole life products from a company without a large block of secondary guarantee product.
- Helping the client weigh the advantages of products that have slightly higher premiums but significantly more cash value—These products will not only give clients additional options down the road in the management of their policy but also the assurance that the company has "real" reserves to back up the cash value.
- Recommending to clients who are purchasing secondary guarantee products that they diversify their coverage among three or four carriers, especially given the potentially harsh consequences of insolvency with this type of product—Many interpret this practice to be a required responsibility of trustees

under Section 3 of the UPIA absent compelling reasons otherwise. For example, a compelling reason not to diversify would be if one carrier considered the insured a standard risk while other carriers would only issue the policy at a significant rating.

- Considering the recommendation of today's hybrid variable products for those clients who are eligible to be long-term equity holders—If these clients understand and can accept short-term volatility in exchange for long-term gain, they should be shown how the new generation of variable products may actually provide both better upside potential and downside protection through separate accounts.

At the end of the day, secondary guarantee products will be a test of insurance companies, regulators, rating agencies and the insurance profession. These products will determine if agents and the industry will continue to "sell" what appears easiest or if they will, indeed, evolve into an advisory model.

Conclusion

Secondary guarantees clearly represent a positive development for conservative clients. They have come at the end of an era of falling interest rates and serve to keep insurance companies from moving the goalposts on clients' planned premium. However, they do not represent a riskless transaction. Current market conditions may represent too much of a good thing. The contract for life insurance is a promise to pay. Rating agencies, companies, and life insurance professionals must make certain that short-term gain on these products does not impair the ability to deliver long-term promises to the families of clients that depend on our products. ■

Lawrence J. Rybka, JD, CFP®, is president of ValMark Securities, an independent broker-dealer that specializes in working with independent insurance professionals across the United States. He is a board member of the Association for Advanced Life Underwriting (AALU) and the MDRT Foundation and served as the insurance content expert for the CFP Board of Examiners. He has been a main platform speaker at the annual meetings of MDRT, AALU, the International Forum and Top of the Table. His published articles on variable and trust-owned life insurance have received industry awards, including first place in the 1997 Journal Author Awards competition from this Journal and the 2002 Financial Planning Article Award from The CFP Board of Standards. Mr. Rybka can be reached at larryj.rybka@valmarksecurities.com.

R. Marshall Jones, JD, CLU, ChFC, AEP, is president of R. Marshall Jones, Inc., a boutique planning firm specializing in family wealth planning and insurance consulting. As an author, Mr. Jones has published two books, *Wealth: Enhancement & Preservation* and *Making Decisions about Life Insurance,* and is a frequent contributor to professional journals. As a speaker, he has lectured at numerous professional organizations, including the annual meeting of the Florida Bar Tax Section and the national meetings of both the Society of FSP and the Association for Advanced Life Underwriting. Mr. Jones can be reached at MarshallJ@RMJplan.com.

(1) Secondary guarantees are a form of universal life where the company promises that, at a given level of premium, the policy will not lapse, regardless of underwriting interest, mortality and expenses. Some in the industry refer to this as a no-lapse premium.

(2) Lawrence S. Rybka, "The Ledger Lie," *Best's Review* (August 1989).

(3) Editorial, "Secondary Guarantees, Marketers, Actuaries, Regulators, and a Potential Financial Disaster for the Life Insurance Business," *The Insurance Forum* 31 (March/April 2004), Nos. 3 and 4.

(4) Jeff A. Mohrenweiser, "Looming Financial Implications of Universal Life" *Fitch Ratings,* 21 July 2004, pp.1.

(5) Ibid.

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