Bill Boersma - Blog

Securities Based Life Insurance; Opportunity or Inevitable Disaster?

Variable life insurance is a form of cash value life insurance where the risk of investment is put squarely on the shoulders of the consumer as opposed to the insurance company. At least in the real old days of the insurance market, investment risk was entirely on the shoulders of the carrier but since we entered the world of projection based life insurance versus guaranteed rates (let's call it the 1970s) more investment risk has been shifted to the shoulders of consumers than they ever realized, even with universal life and many whole life insurance policies. But this is nothing compared to risk transfer involved in variable life insurance policies.

Let me be clear, variable life insurance can be an incredibly valuable tool when understood and managed appropriately.

The problem is, from my experience, the instances of clear understanding and appropriate management are few and far between.

Why do people buy a stock market based life insurance policy? Theoretically it is because of upside potential. Simplistically, if you as a consumer feel you can outperform the fixed interest rate offered in more traditional life insurance products, and you are willing to accept the risk, the upside potential can be quite significant. There are clearly instances where variable life insurance is the appropriate tool for the job.

In reality, many consumers don't buy variable life insurance policies as much as they are sold variable life insurance policies. Like clockwork, variable life sales spike when the markets are doing well. It seems to be an inevitable consumer mentality that if it is sunny now, it will always be sunny. Buying high is one of the oldest traditions of the consumer market. It is amazing the percentage of variable policies which come across my desk for audit which have a policy date of 1998 through 2000. Why? When a consumer is shown a ledger assuming 12% rate of return (maximum allowed and often shown back then), the premiums are incredibly low and/or the cash value and death benefit projects to reach the stratosphere in the future.

The irony is that a variable life insurance policy was never constructed to be a spreadsheet player for competitive purposes. Quite the opposite, variable life works best when the consumer mentality is "How much can I put into this thing" versus "How little can I pay". The eleventh commandment "Thou Shall Not Pay Too Much" is a mentality directly opposed to the proper mentality regarding variable life. Given the opportunity and competition in the streets, the product has been horribly abused in many instances.

In addition to proper funding of a variable life insurance policy, active management is of paramount importance. I often say that life insurance needs to be managed like any other financial asset but when it comes to variable life insurance, this statement is not accurate. This is because variable life insurance has to be more closely managed than other investments due to how the policy actually works. In reality it is often the one securities based asset which gets literally no ongoing management. It will be impossible to get into the gritty details of the internal machinations of a variable life policy in this entry but let me make a couple of observations.

First of all, the expenses in this form of insurance are significant. This alone is not a reason to shy away but a reason to provide cause for clearly understanding how these expenses affect the performance of a policy and how to manage them.

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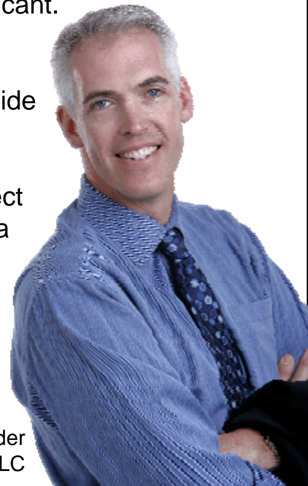

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More importantly is the fact that it very much matters exactly when the return is earned in a variable policy, much more so than traditional investments. Generally, sales ledgers assume a return which will be absolutely level for the life of the policy. The one thing we can guarantee is that this will not happen; there will be up years and down years and this affects policy performance more than most people could possibly imagine. Why does this affect a policy? – Because expenses and mortality charges are a factor of the cash value of the policy. Here is an example; let's assume a consumer procured a variable policy 20 years ago and the cash value of his $1,000,000 policy is $500,000. If he was invested in growth style sub accounts (which he really needs to be in order for the policy to have a chance of persisting) during the recent market downturn he may have lost a couple hundred thousand dollars in cash value. What does this mean to the expenses in the policy? Well, since the mortality charges of the policy are based on the "amount at risk" which is the spread between the death benefit and the cash value, the mortality charges withdrawn for the cash value increase maybe 40% when the sub accounts take such a hit. This is akin to your retirement fund manager substantively increasing charges when the market tanks and your account levels drop off a cliff… kicking you while you are down effectively. All of this happens when the insured is older and the mortality charges are substantively increasing. The payment of higher charges causes the account to decline further causing the net amount at risk to increase which leads to higher charges which causes the account to decline further which …. You get the idea. What I see over and over again is the creation of a death spiral or a negative vortex.

> Most variable policies were significantly underperforming and had little hope of long term success before the recent downturn.

At this point the infusion of capital required to rescue them is so dramatic that many policy owners who have been on the receiving end of an objective evaluation are choosing to bail out and look for alternate opportunities.

In the course of variable policy management and review, stochastic modeling is imperative. Randomizing the unknown elements to a statistically significant degree to infer a probability of success for given funding parameters is essential. In other words, the stock in-force ledgers received from carriers in an effort to project policy performance are largely worthless when attempting to bring a meaningful level of management and advice to the table. The modeling and the resources are available and the variable life policy owners need this level of advice whether they realize it or not. The results of not doing so are not pretty.

Once again I am sure there are those in the industry and the field who will state that this is not how it is. All I can expound on with 100% accuracy is the actual experience we have with what comes into my office. What we know for certain is that policies which project to pay a death benefit at life expectancy, let alone policy maturity, without a substantial infusion of capital are few and far between. And this is based on carrier projections and not stochastic modeling which is more meaningful and illustrates a more realistic chance of policy success (usually lower). In closing I'll repeat it one more time for the record. This commentary is not intended to drive anyone away from variable life insurance or to insinuate buying/selling such a product is inappropriate, but it is a plea to make sure you and your clients understand it and manage it appropriately. If you don't understand what that takes, we need to talk.

By the way, this blog entry is peppered with verbiage and facts which should be credited to Richard Weber.

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