A Closer Look

Is Your Life Insurance Living Up to Expectations?

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In Brief

- **Many permanent life insurance policies may be underperforming original projections.**
- **While some of this underperformance can be traced back to the timing and amount of premium payments, or perhaps equity market volatility, much of it stems from an extended period of low interest rates that has impacted insurance carrier general account yields and resulted in declining interest and dividend crediting rates.**
- **Gradually increasing interest rates going forward may not change this dynamic for many years.**
- **A review of your life insurance policy can determine whether it offers worthwhile benefits or if it makes sense to modify it or seek alternatives.**

A Thorough Policy Review Is the First Step

Life insurance has long been considered an effective estate planning tool given its potential for creating liquidity through tax-free death benefits to fund estate taxes.

That said, the performance of many life insurance policies may be failing to match original forecasts — and may well have been doing so for years. The specific reasons vary depending upon the particular type of policy. In some cases, underperformance can be the result of variability in the timing and amounts of premium payments. In others, stock market fluctuations can have a negative impact on policy performance. In many cases, however, the underperformance can be traced back to the multi-decade decline in interest rates, which has impacted the profitability of insurance carriers and resulted in sustained declines in interest and dividend crediting rates. Going forward, insurance carrier crediting rates are likely to lag gradually increasing interest rates for many years.

This does not mean life insurance can no longer be an attractive option for estate planning and other purposes. It really depends on the type of policy you have and its specific characteristics, as well as your particular situation, risk tolerance, and goals. An objective, in-depth review of your policy is crucial in determining whether it makes sense to hold on to your policy, modify it, or seek alternatives.

The Role of Interest Rates

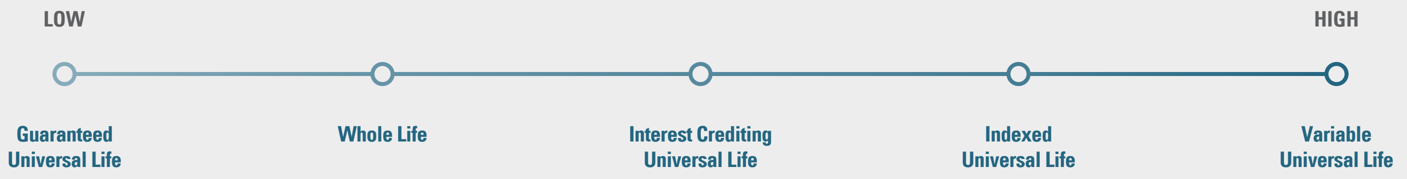
While universal life and whole life insurance policies are different in many ways, both are sensitive to prevailing interest rates.

For a number of reasons, chief among them the regulatory requirement to support their obligations with safe investments, insurance carriers tend to invest most — upwards of 80% — of their general account assets in high-quality bonds and mortgages.

Since interest rates have been — at least until recently — trending downward for more than 30 years, the yields on these high-quality fixed income investments have been declining accordingly.

In short, insurers have been earning increasingly less from their fixed income investments.

Exhibit 1: Variability in Returns by Policy Type*



* See Glossary of Terms on page 6.

Source: Bessemer

This impacts universal life and whole life policies, but in slightly different ways:

Universal life insurance. Insurance carriers' interest crediting rates — the amount of money credited to universal life policy cash value accounts — are tied to general account yields (e.g., insurance carrier profits). Since general account yields have been falling, the interest crediting rates for many of these policies have been, and remain, under downward pressure. For policy owners, this could mean additional premium payments or lapsed policies. In certain circumstances, policies designed to have increasing death benefits could see less growth than expected.

Whole life policies. While they do not receive interest crediting rates, whole life policies do receive dividends, a return of premium based on the insurer's profitability. More specifically, the dividend is based on three factors — the general account yield, the mortality experience of the carrier, and the carrier's operational expenses. Low interest rates, mortality rates that exceed assumptions, and/or increased operational expenses (such as rising healthcare costs for employees) can all negatively impact dividends.

In fact, dividend rates have decreased consistently and significantly — in some cases, close to 75% — in the last 30 years. For policy owners, this has a number of potential implications:

- Death benefit and cash value growth may be less strong than originally projected.
- In cases where projections called for premiums to be paid with dividends, additional out-of-pocket premiums may be required.
- Policies with premiums that have previously been offset by dividends may instead be taking automatic policy loans, which can have a negative impact on policy performance.

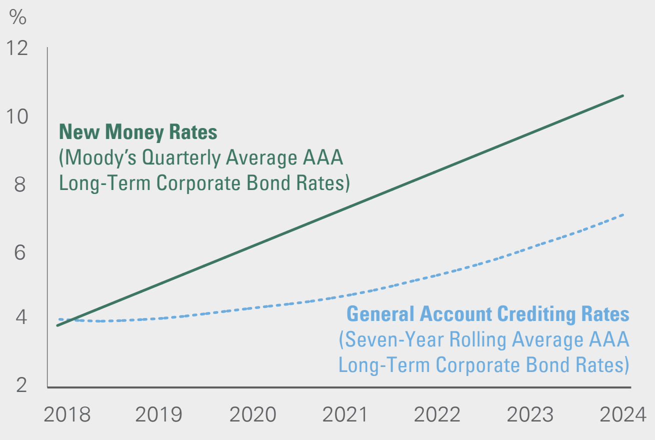
Rising Interest Rates

Even with interest rates finally nosing upward, many policies could still see a lengthy period of downward pressure before performance improves at all.

A likely gradual increase in interest rates is not likely to contribute meaningfully to policy performance for years to come. As shown in Exhibit 2, the green line represents

Exhibit 2: Carrier General Account Lag Factor

Key Takeaway: A gradual increase in new money rates will outpace general account crediting rates significantly for years to come.



Data as of 3/30. Assumes 25 bp increase per quarter.

Source: Bessemer, Moody's

the new money rate (Moody's AAA long-term corporate bond yields) hypothetically rising steadily over the next seven years; the blue line, which represents the seven-year rolling average (a conservative proxy for life insurance company crediting rates), wouldn't rise significantly until year four, and wouldn't even begin to close the gap at seven years.

In addition, in pursuit of higher yields, some insurance carriers have been migrating to slightly more risky and less liquid longer-term bonds, which will trail new money rates for longer given their longer duration. This should only serve to exacerbate the performance lag factor.

Of course, if interest rates were to rise more quickly than we're expecting, crediting rates would rise faster as well, but meaningful increases would still likely be several years out. In addition, rapid rate increases would actually place stress on carriers as they struggle to provide a competitive crediting rate while also dealing with policy owners cashing out to pursue higher-yielding investments elsewhere.

For **No Lapse Guarantee (NLG)** policies, since the death benefit and duration of coverage are guaranteed as long as premiums are paid as scheduled, downward pressure on rates is irrelevant. However, if you own an NLG policy, you should keep an eye on inflation. Since they tend to have low or no cash values, they won't benefit from, and may permanently lag, an extended high-interest-rate environment.

Other Factors Impacting Performance

Premium amounts and timing. Beyond interest rates, your own decisions as a policy owner can impact the performance of your life insurance policy. When it comes to **universal life insurance,** for instance, policy owners can vary the timing and amount of their premium payments, and even skip a payment, as long as there's sufficient cash value in the policy.

In some ways, this can be helpful, but it has a potential downside. If you don't maintain the original funding schedule, even if your policy is experiencing what appears to be solid cash value accumulation, it will not perform as originally projected.

Whole life insurance, on the other hand, has a fixed premium schedule; if you skip a payment, the policy will take a premium loan against itself to pay the premium. This can work for a while, depending on the cash value in your account, but accruing loan interest in principal can hurt your policy's long-term performance.

Investments and market volatility. In comparison with traditional universal life and whole life insurance, **variable universal life (VUL)** policies offer greater potential for cash value accumulation if the underlying investments outperform fixed income over a sustained period of time.

VUL policy owners have the ability to select from a wide variety of fund offerings, so they may or may not do well with this approach depending upon their choices and the market environment.

A major issue, however, is that VUL projections, both at the time of sale and during periodic reviews, generally assume a static return (an 8% year-over-year return, for example). In other words, VUL projections do not account for the inevitable impact of market volatility on policy performance.

As an example, negative investment returns will increase the policy's net amount at risk — the difference between the policy's current cash value and the death benefit — and the carrier will increase the cost of insurance charges as a result. Imagine an insurance policy with a $1 million death benefit and a $500,000 cash value; in this case, the insurance company only charges for $500,000 ($1 million minus the $500,000 cash value). If the market experiences a correction, bringing the policy's cash value down to $400,000, the net risk changes proportionately, to $600,000, increasing the cost of insurance charges. Additionally, if the carrier liquidates underlying investments to pay for the increased cost of insurance charges, there is less cash value to appreciate when the market eventually turns around.

Indexed universal life (IUL) insurance shares certain characteristics with VUL and interest crediting universal life, but carriers credit the policy's cash value based on the performance of an index, such as the S&P 500 — at least up to a point. With IULs, both the downside risk and the upside potential are limited; that is, they provide a guaranteed minimum rate of return, such as 0%, and a non-guaranteed cap rate set by the carrier — at present, typically between 8% and 12%.

Since cap rates are not guaranteed, however, the carrier can reduce them at any time, thereby negatively affecting policy performance. The cap rates are determined in large part by the carrier's general account yields, or the budget available to buy options. If its general account yields fall, it has less money to purchase options on the designated indices. So the carrier's ability to maintain, increase, or decrease a policy's cap rate is based largely on its own general account yields.

Another major factor that contributes to a carrier's ability to maintain its indexed cap rate is the cost of options. Over the long term, there may be increased pressure to reduce cap rates if the cost of options increases due to an expectation of increasing market volatility.

So far this year, in fact, market volatility has increased markedly, and investor expectations for market volatility (as measured by the Volatility Index, or VIX) are up significantly as well.

It's also worth noting that if the total return of the designated index includes a dividend yield (as the S&P 500's does), growth-rate calculations for determining cap rates would only use index appreciation and exclude dividend yield.

And again, similar to other universal life policies, potential issues can arise when it comes to assumed return projections at the time the policy is issued and during periodic reviews. Hypothetical indexed crediting rates are based on the historical performance of the designated index, and current cap rates are not necessarily an accurate predictor of the policy's future performance. It's important to make realistic and conservative return assumptions when acquiring and monitoring these policies.

What Should You Do With Your Policy?

If it turns out that you have a policy that is underperforming your expectations, should you stay the course or abandon it?

Exhibit 3: Universal Life Policy Performance — Example

Key Takeaway: Policy performance continues to rely heavily on crediting rates and fixed income rates in general. In-depth analysis at the point of sale and in-force service reviews are critical to long-term success.

Male Age 55, Preferred Non-Smoker, $10,000,000 Death Benefit				
	Annual Premium	Current Crediting Rates	Projected Lapse	Projected Lapse Assuming Crediting Rates Decrease by 1.00%
Carrier A	$106,871	5.05%	Age 120	Age 93
Carrier B	$111,907	3.75%	Age 105	Age 100
Alternative: Assume 1.00% Below Current Crediting Rates, Solve to Age 100				
Carrier A	$118,864	4.05%	Age 100	
Carrier B	$111,907	2.75%	Age 100	

Source: Bessemer

The best course of action is not always immediately obvious. For instance, in Exhibit 3, Carrier A's policy seems at first glance to be a better option than Carrier B's policy; both offer an identical death benefit, but Carrier A requires lower premiums and provides a longer duration (if crediting rates remain stable). Re-examining the two policies with a more conservative stress-tested crediting-rate forecast (one percentage point lower than the original forecast), however, we can see that Carrier A's premiums rise markedly while the crediting rates fall. Carrier B's policy becomes the better option.

Objective policy reviews are essential — before a new purchase and then regularly thereafter — to see how your policy is holding up. Particularly given the outlook for continued pressure on crediting rates, reviews that include downside stress testing to show how different (lower) crediting rates are likely to impact performance can help to determine reasonable funding levels — for both prospective and already-owned policies.

At that point, you can begin to weigh your options.

If you're considering a new policy, make sure you know the risks of each policy type and design your policy conservatively around those risks.

For your existing policies, you should periodically review your investment allocations, track your policy's performance to make sure the funding stays on track, and always use conservative appreciation projections to help ensure they remain in line with actual performance.

Finally, a thorough policy review can put you in a better position to decide whether to retain your policy, modify it, exchange the policy for a different type of insurance, or simply allow it to lapse.

Permanent life insurance policies are likely to remain under pressure for some time to come. But this does not necessarily mean they are inappropriate or even unattractive assets. Determining whether it is right for you depends upon the results of an objective policy review and a realistic assessment of your particular objectives and personal circumstances.

If you have any questions or would like to learn more about this subject in the context of your personal situation, Bessemer's insurance advisors are happy to speak with you. Please contact your client service team or your local Bessemer Trust office.

Glossary of Terms

General account: The account where an insurer deposits its combined assets received from policy holder premium payments. The general account is available to pay operating expenses, claims, dividend payouts, and credit interest to policy holders. Typically, insurers invest upwards of 80% to 85% of their general account assets in investment-grade bonds and mortgage investments.

General account yield: The total income produced by all of an insurer's general account investments, expressed as an annual percentage of the total value of the account.

Interest-crediting universal life insurance (UL): a permanent flexible-premium policy. The timing and amount of premium payments may vary as long as there is enough cash value to cover monthly cost of insurance deductions. Interest is credited based on the yield of the insurance company's general account and is highly dependent on fixed income rates.

Guaranteed universal life insurance (GUL): A permanent flexible-premium universal life policy with a focus on long-term, guaranteed death benefits.

Indexed universal life insurance (IUL): A permanent flexible-premium universal policy type, but cash values can be allocated to market-based indices, such as the S&P 500.

Universal life cost of insurance charges (COIs): Monthly deductions withdrawn from universal life cash value by the insurer to support the policy's death benefit. COIs generally increase annually based on the insured's age. As long as there is enough cash value to cover monthly deductions, the coverage should continue. If the cash value is insufficient, additional premiums will be required, or the policy may lapse.

Universal life interest crediting rate: The rate at which an insurer credits a universal life policy's account value. Highly dependent on insurer's general account yield and fixed interest rates, interest credited to a universal life policy will help offset cost of insurance charges.

Whole life insurance: permanent coverage with a fixed premium schedule. The policy earns dividends based on the company's profitability that may be used to reduce or eliminate the need for cash premium payments, increase the policy values, or be paid out in cash.

Whole life dividend: A return of premium based on the insurer's profitability. Highly dependent on the insurer's general account yield and fixed interest rates, dividends can be used to reduce or eliminate cash premium payments, increase policy values, or be paid out in cash to whole life policy owners.

Source: Bessemer

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