Life Insurance in Estate Planning

By Joel Kabaker

Universal Life Insurance—A Ticking Time Bomb

Universal life insurance is a policy concept that may have reached the end of its useful term. Indeed, for many estate planners, it is a ticking time bomb, especially those written before the no-lapse guarantee provisions were added. The reason is that many older universal life policies are currently performing nowhere near their original illustrations. This can create a significant insufficiency of cash flow, often when the estate plan needs it the most. One cause is interest crediting rates (the rate at which investment income flows into the account) are at an all-time low for such policies. This means that the policy is not throwing off nearly as much cash flow as the estate planner thought it would. Further, the costs and expenses that are charged to these policies by the insurance companies are now much greater than when they were first purchased. Mortality charges are also substantially greater than those originally assumed in the contracts when they were first written and illustrated. This means that the insurance companies are now loading each policy with more cost of death benefits paid. Note that the carriers do not have to request permission from their state's insurance commissioners to alter mortality charges. All these additional and unplanned costs are the insurance equivalent of a stock margin call to policy holders and their financial advisors.

With interest rates flat or declining and volatility in the securities markets increasing, universal life insurance can actually defeat the purpose for which so many estate planners originally employed it. Here is why. Universal life insurance is a permanent life insurance policy with characteristics similar to its cousin, whole life. The biggest difference is that the insured shares the risk of maintaining the death benefit in a universal life policy. The universal policy

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will lapse if the cash value or premium payments fall below the cost of insurance. Whole life policies, on the other hand, guarantee the death benefit so long as the premiums are paid.

Universal life premium payments are credited to the insured's account along with interest income but net of insurance costs. This allows the policy owner certain discretion to increase or decrease premium payments as their financial situation changes over time. During peak earning years, for example, they may elect to increase premiums and build the cash value. During the retirement years, they can reduce or even skip premium payments, allowing the built-up cash value to cover the deficiency. Likewise, the estate planner can adjust the death benefit downward to accommodate targeted premium payments while still maintaining a desired level of insurance coverage.

Watch for more planners seeking to avoid insurance policies where the cost is indeterminate.

The advantage of using a universal life insurance policy was its greater potential cash value growth so long as interest rates outperformed the insurer's general account. Should this occur, policy holders would receive an increase in earnings credits. Nice in theory. However, in practice, policy holders seldom, if ever, receive a step-up in earnings credits. Further, given the current economic climate, earnings reductions are far more likely to continue.

Insurance companies created several spin-offs in an attempt to solve this problem. There is the variable universal life product that allows managers to direct excess cash value to a number of separate investment accounts—mutual funds, stocks and bonds. Presumably, this allows savvy planners the limited ability to manage the cash build-up as if it were an investment portfolio. There is also the equity indexed universal life contract that allows investment in index options based on a specified index movement such as the S&P 500, the Dow Industrials or the Russell 2000.

The Problem Defined

Two significant problems face estate planning professionals using universal life insurance policies to accomplish part of their financial strategy. First is the real possibility that clients will outlive their policies unless they significantly raise their premium payments. After all, as the earnings credits fall due to the current interest rate environment and as mortality costs continue to rise, something has to bridge the shortfall between the cash value and the death benefit. That obligation falls on the shoulders of the policy holder, or more practically, on their financial and estate planners.

The second problem is the liability exposure faced by the estate planning professionals who did not see this premium hike coming. Cash is diverted from the planner's intended purpose, such as making generational gifts, to the insurance company just to maintain the policy at targeted levels. Additionally, the death benefits funding certain other estate planning needs could be well below that on which the planner was counting.

Solutions

Current market conditions present not only the need to make some changes, but an opportunity for professional estate planners to better serve their clients. For clients who own a universal life policy that is not performing as intended, there are three potential solutions:

1. **Sell the policy.** If the insured is healthy and over 70, they can sell the policy to the life settlement industry. This frees the funds needed to buy a new policy that is more appropriate for their circumstances.
2. **Averaging the premium increase over time.** If a client is not healthy, they can over fund current and future premiums over the short term. This gets the policy re-rated today, rather than later. Such a strategy keeps the premium lower than it would have been otherwise—essentially averaging the increase over a longer period of time.
3. **Minimum funding.** For policies that will be sold when the time is right (*i.e.,* when the insured reaches their mid-70s) pay just the actual cost of insurance determined by the carrier to keep the policy in force. This is at best a short-term solution and only for clients up to their mid-70s. Beyond that, the annual mortality charges rise too high, too fast. This solution buys the time needed to sell the policy (strategy 1 above) without tapping needed cash flow more than absolutely necessary.

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Trends in Universal Life

Watch for more planners seeking to avoid insurance policies where the cost is indeterminate. Historically, universal life policies were such animals. However, the latest generation of universal life policies offers a guaranteed death benefit for a guaranteed premium, thus merging two major attributes of a whole life policy. Beware, however, the guaranteed cost universal life policy will most likely never have any cash surrender value. Therefore, estate planners should use it as term insurance renewable for life. Further, if the premium on this policy is not paid on or before the exact due date, if the holder skips a premium or if they borrow from the policy the guarantee automatically becomes null and void. This means the policy will be re-rated when the cash surrender value becomes zero and the cost of insurance exceeds the premium. At that time the premiums could be exponentially greater than they were originally for the holder to continue with the policy, potentially, a very expensive proposition. Further, the carrier is under no obligation to inform the policy holder at the time the guarantee is voided.

With these costly attributes to universal policies, estate planners seeking guaranteed costs and death benefits will likely gravitate to traditional whole life insurance. Removing the risk of cost escalation simply to maintain targeted insurance coverage and cash value levels makes the job of estate planning that much more certain.

Additionally, look for a trend in policies that discount the premium for a finite number of years. Such insurance policies include guaranteed cost universal life policies. This allows use of the spread between the discount and normal premium to be employed for more immediate uses like funding the grandchildren's educational trusts. Many planners seek a guaranteed step-up in premiums. This further takes the guess work out of planning for insurance costs. Policies like discounted premium, guaranteed cost universal life will increase in favor among the savvy estate planning professionals.

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