Richard M. Weber, MBA, CLU

NAIC Consumer Representative

Life Insurance
Consumer Advocacy Center

We are working with a number of current consumer complaints and litigation due to the misleading **policy illustrations** projecting indexed life and annuity values

Issues of the Life Insurance Illustration Model #582 (1995) and Indexed Universal Life

- There is no disciplined scale in IUL (or VUL). AG49 and its updates only address allowable illustration rates and features, not other important issues!

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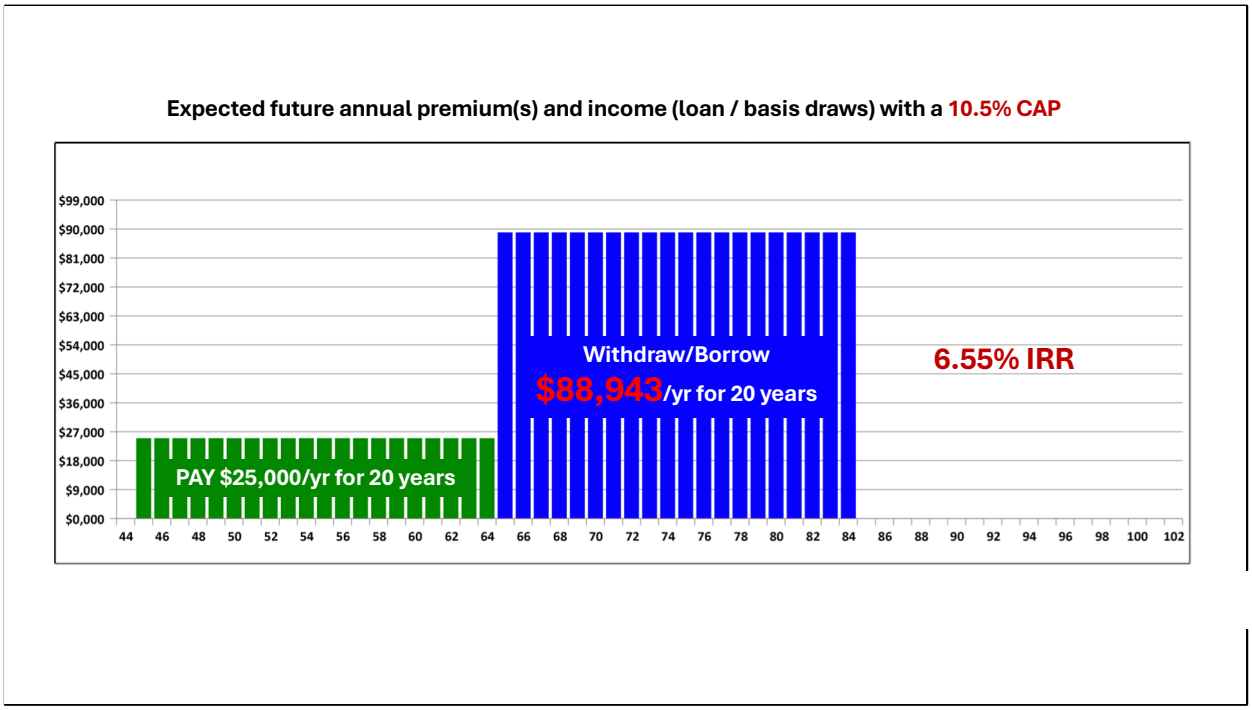
- "The best a policy will ever look is when it is first depicted in a sales illustration."

A practical analysis of these issues

Income-tax-free Retirement Income via IUL Life Insurance

We estimate as much as 70% of IUL sales to High Net Worth customers are focused on “income-tax-free_ retirement income RATHER THAN the death benefit!

The Illusion within the Illustration



Life insurance has unique tax benefits. As you know, cash value accrues without current taxation, and the death benefit is income tax-free. However, these benefits will be lost retroactively if the policy terminates – for any reason – prior to death.

The sales approach shown here with a current life insurance illustration suggests that if the client pays $25,000 a year into the policy from age 45 to age 64 – she can then withdraw almost $89,000 a year beginning at age 65 for the next 20 years. The result – not including a residual death benefit paid upon death – is a cash-on-cash IRR of 6.55% - a very reasonable return for this asset class.

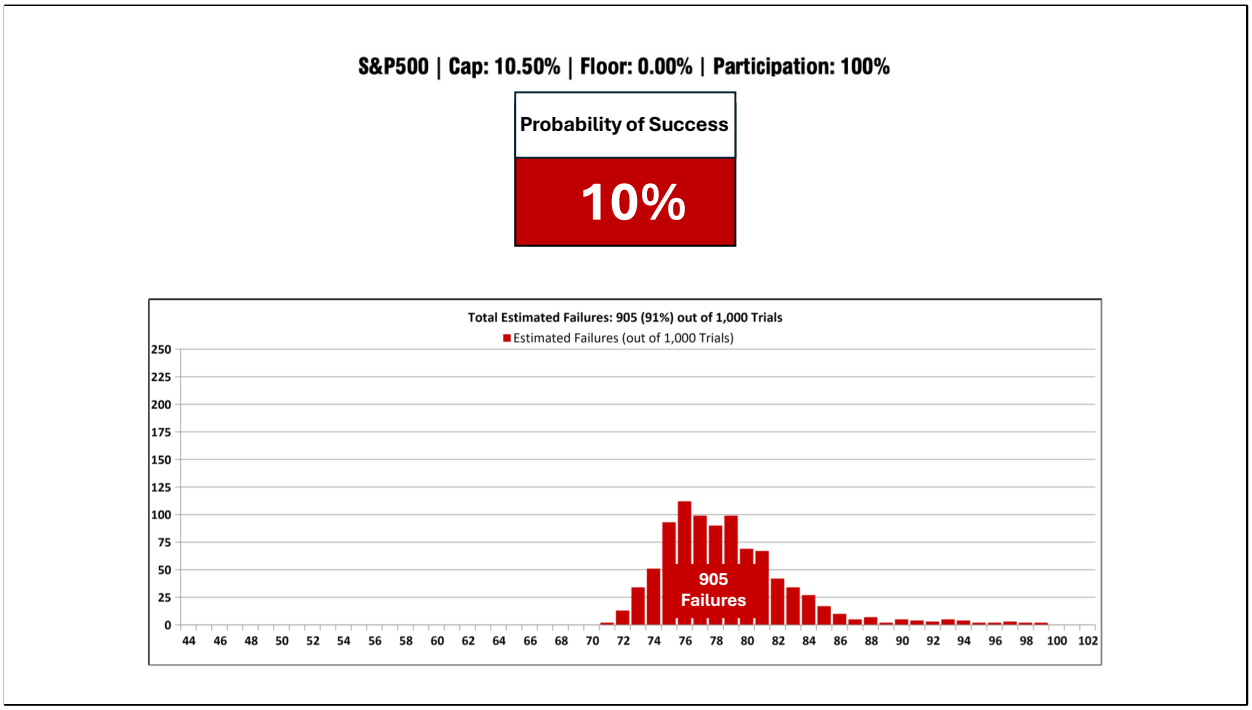
S&P500 | Cap: 10.50% | Floor: 0.00% | Participation: 100%

1000 Trials with Random Crediting Rates

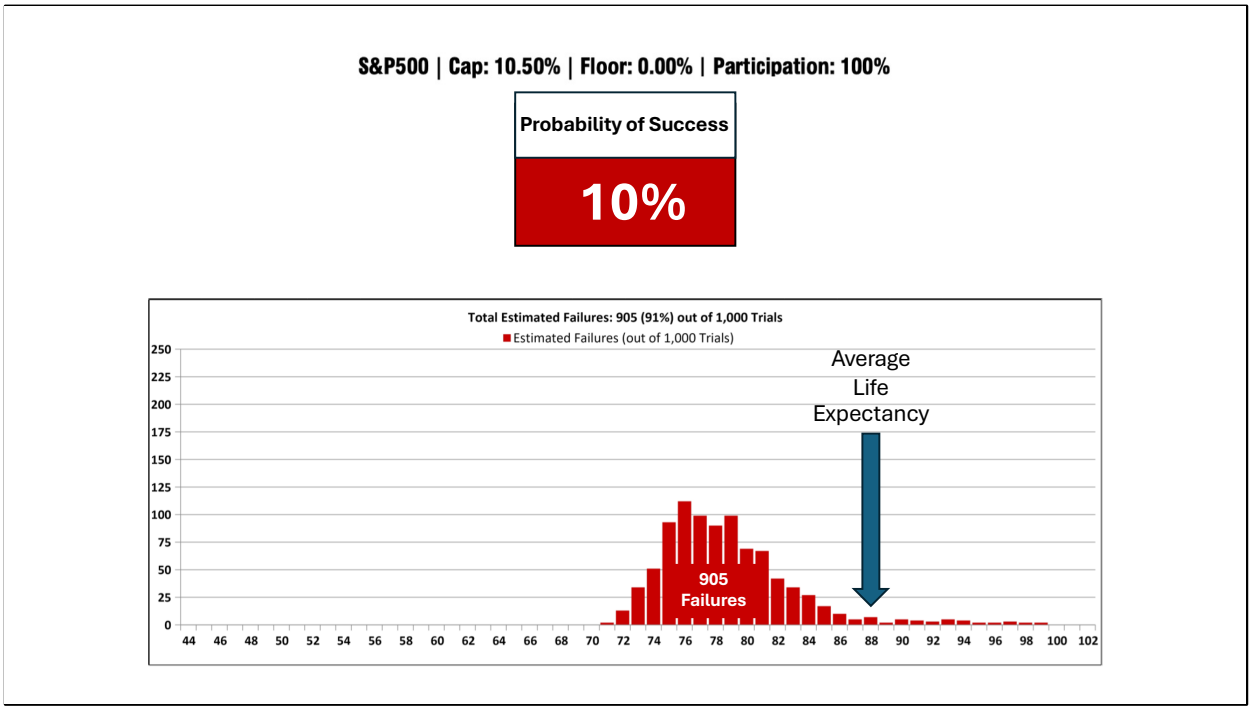
These numbers and values were derived from an Indexed Universal Life policy illustration with an AG49 determined 6.6% illustration rate on cash values before expenses – but as is customary with these types of policies – the 6.6% illustration rate is applied as a constant across the next 80 years when the illustration calculates account value and death benefit values. Clients generally are not aware of this, and surprisingly, many agents are equally unaware.

CFP professionals routinely use stochastic analysis to project the likelihood of success of any growth and distribution plan for a client's retirement intentions, but rarely seek comparable analytics when it comes to life insurance products for which the growth factors are merely assumed to be constant rather than reflect the inherent ups and downs – albeit within the **current** cap and the guaranteed floor of accumulation rates.

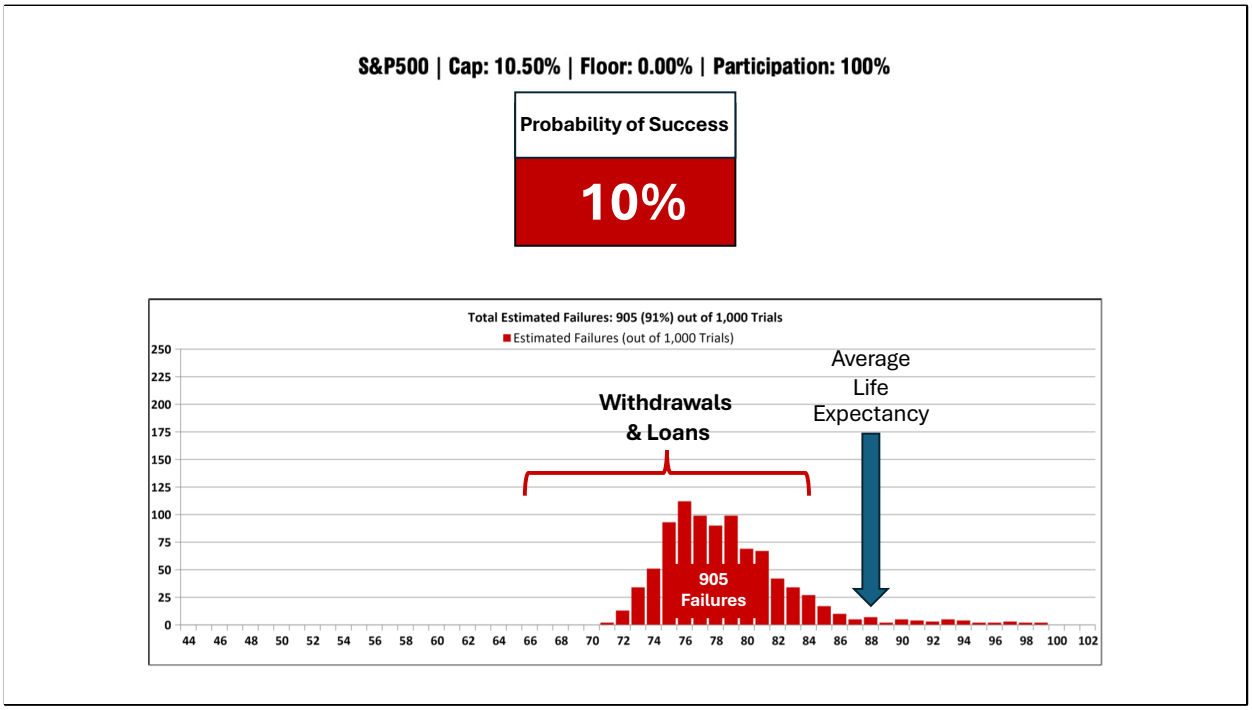
In the example I'll show you, we've run **1000 trials** of the same illustrated premiums, benefits, and death benefits. The only difference in the 1000 trials is that we substitute those constant annual illustration rates with randomized returns of historic activity *in that index – here the S&P500*. This is the same process planners use with accumulation and "de-cumulation" scenarios – introduced in the context of understanding how the policy's accumulation values – and future withdrawals and loans - are likely to behave in the real world.



This result is not anything like what the client expected! The illustration implied 100% likelihood of completing the task of providing cash value withdrawals and an ultimate death benefit. Instead, in a rigorously applied stochastic analysis generating 1000 trials – the probability of successfully paying out the expected "retirement" cash flow and keeping the tax benefits - is just 10%.

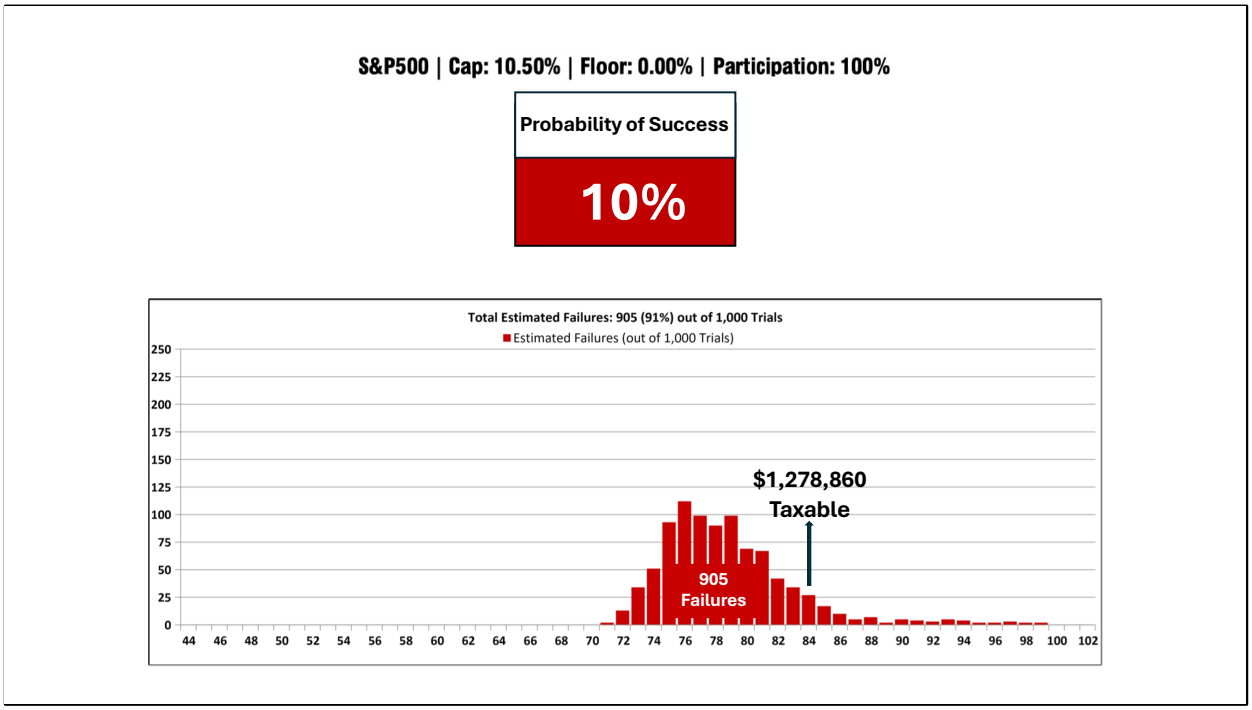


"Success" is defined as the policy sustaining to at least age 100. As we note here, more than 80% of policy failures are likely to occur before the insured's AVERAGE life expectancy …



... and that while there are no failures in the first 5 years of account value withdrawals within the 1000 trials, most of the failures will occur sometime during the expected period of withdrawing and borrowing $89,000 a year – tax-free.

And what happens when the failure DOES occur? Assuming it happens right after taking 20 "times" $89,000 from the policy between ages 65 and 84 ...

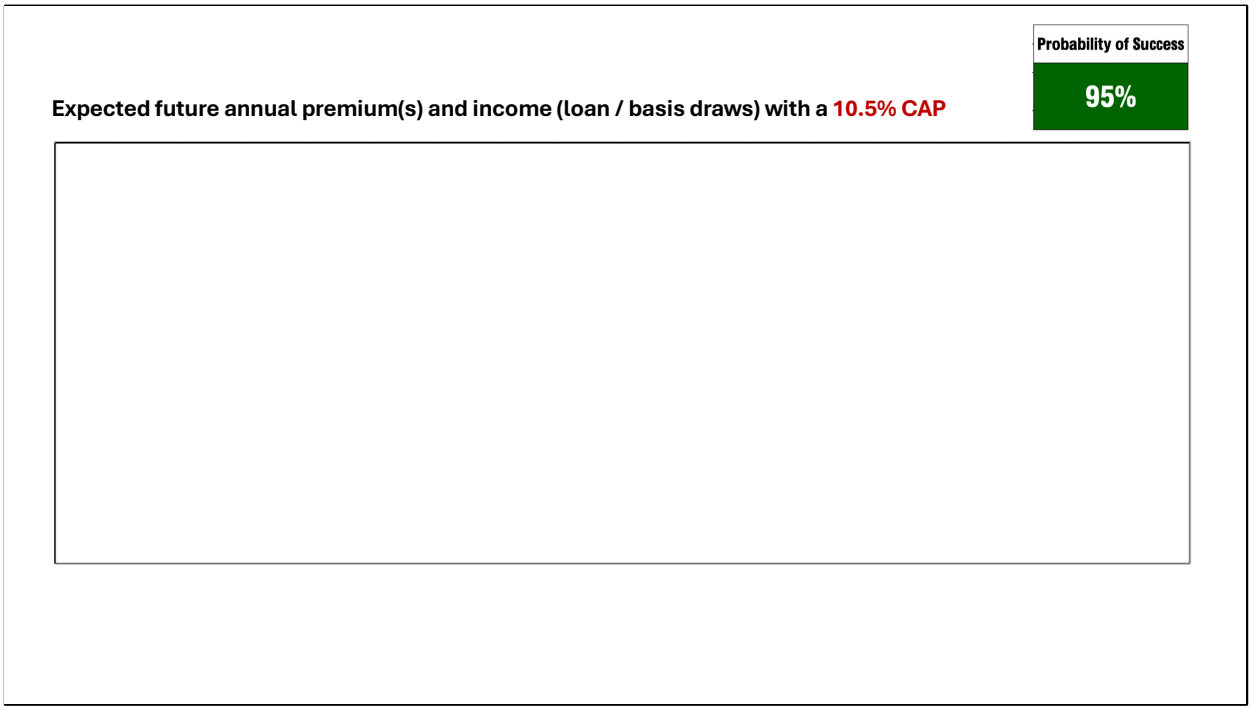


... the insurance company will send a 1099 to the IRS for the taxable gain (total withdrawals minus premium basis) – all in the year of the policy failure – and all subject to ordinary income tax.

We've yet to find a client who was made aware of this potential risk.

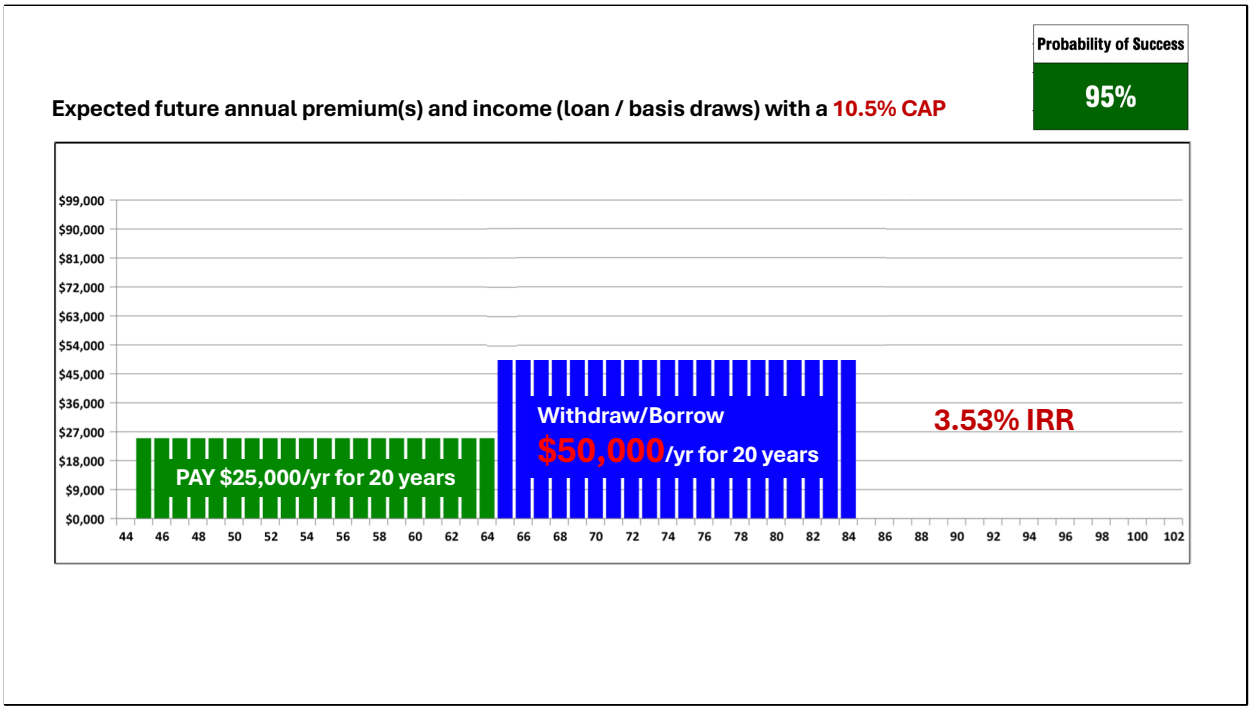
How are we going to fix this?

The CFP professional or IAR may not have suggested this plan to the client – and while likely to have been recommended by someone else - the client is likely to turn to their trusted advisor for their evaluation and recommendation.



What's YOUR minimum probability of success when deciding whether to make a long-term financial commitment? Our experience is that consumers are in a 90-95% threshold.

Stochastic analysis allows us to re-do the 1000 trials, solving for an account value withdrawal that will meet the client's HIGH required probability of success. With the current cap of 10.5%, it will be necessary to lower the expectation of $89,000 to $50,000 a year to solve for a 95% probability of success. The resulting cash-on-cash IRR of 3.53% is almost 50% less than the original proposal.



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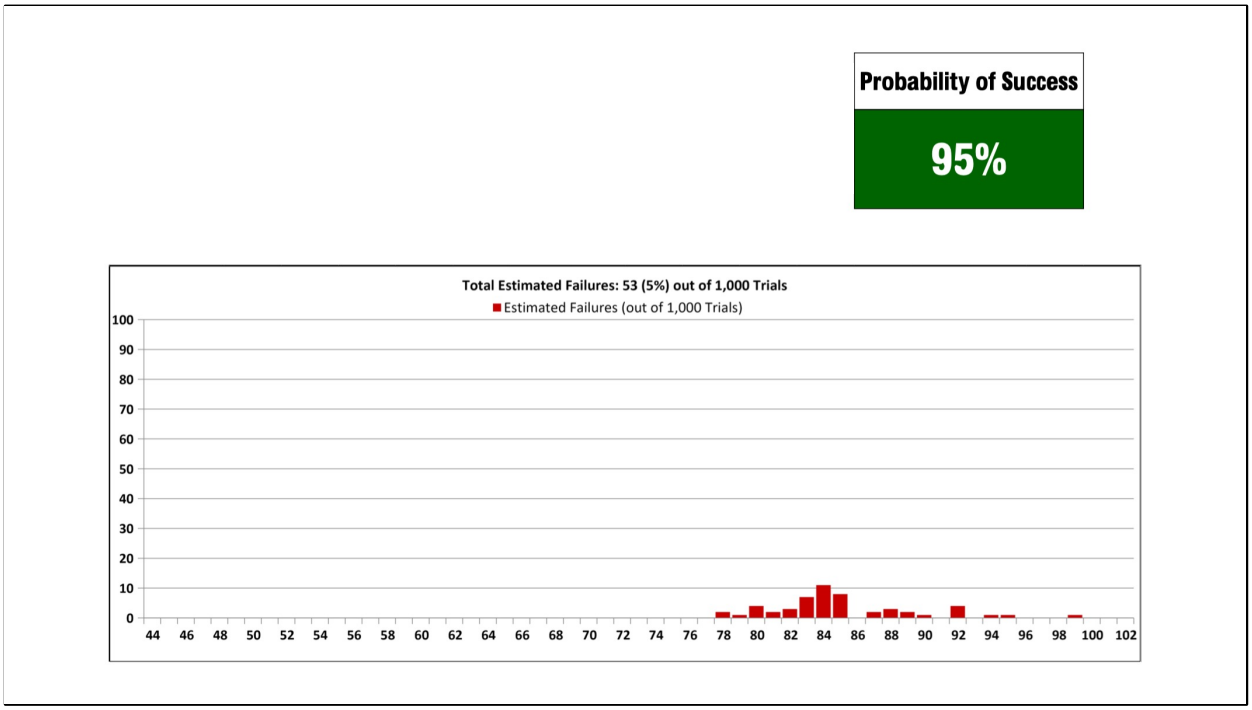


It's important to point out there are still 53 suggested failures along the way – starting at age 78 – but these are nominal outliers within the high probability of success. Management of the process over the many years underlying this plan can reveal if any of these suggested failures are likely to occur – in time to take corrective action and achieve the expected benefits.

CAPTASTROPHY!

But then there's the problem of CAPTASTROPNY!

Indexed Universal Life policies are typically CAPPED for Index returns – today in the range of 8% to 10% depending on the Index. But at least one insurance company's initial CAP was 18% when its policy was sold in 2011. Today's in-force CAP – on the policies previously sold – is now 7.5%.

This is another nuance not well understood: with Indexed Universal Life policies, the insurance company has control of many of the elements that illustrate superior performance for the policy owner – yet CAPTASTROPHY is never taken into account in the policy illustration.

CAPTASTROPHY!

10.5% Cap

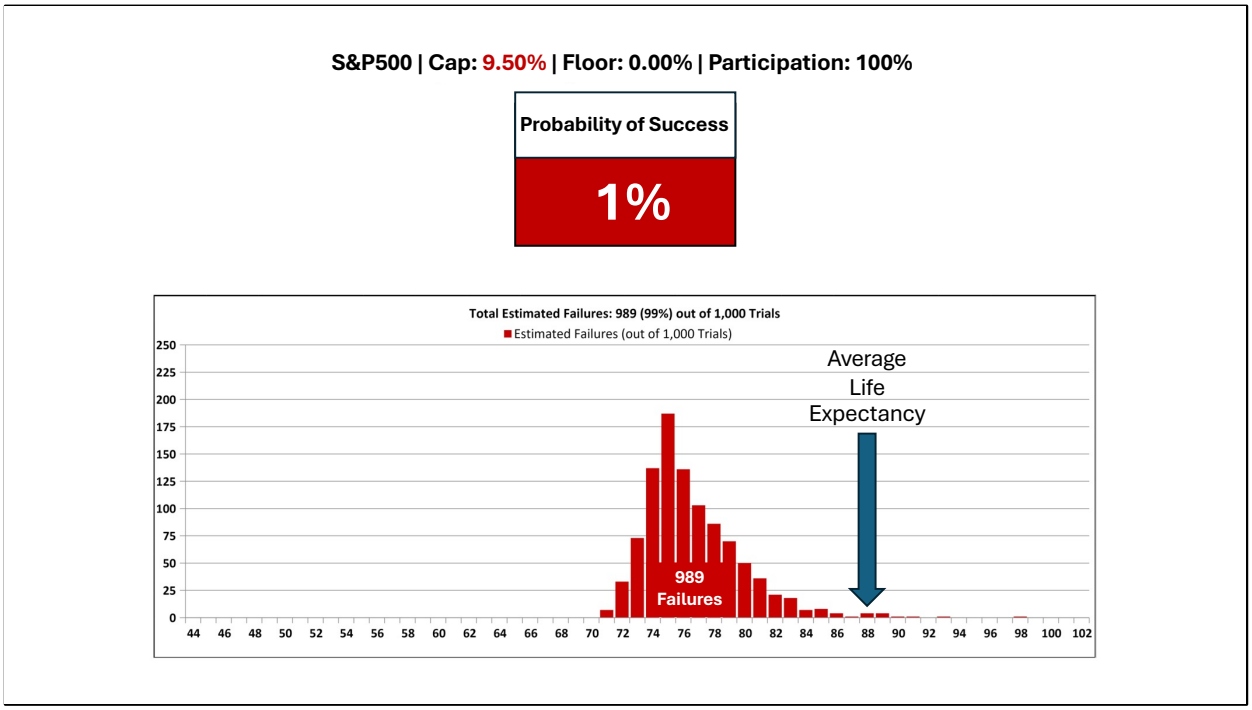
9.5% Cap

The policy illustration isn't designed to demonstrate the effect of a lower CAP on a policy that may be in effect for 40 – 60 years, yet there is a virtual certainty that CAPS will change over time. Since 2018, CAPS on existing policies have predominantly moved lower from what was contemplated when first purchased, and this can further erode the *probability of success*.

Further, while the CAP will be referenced narratively in the policy illustration, it doesn't not enter into the numerical summary and projection of future values since the CAP will always be greater than the illustrated rate – at least initially. It's the IN- FORCE effect of a changing CAP RATE that is difficult to explain to the client.

Stochastic analysis is the only means of bringing the CAP into the analysis, since the stochastic range of random returns is dictated by the guaranteed minimum and CURRENT CAP.

In the following example - to visualize the effect of a lower CAP - we narrow the range of possible returns to that of a 0% guaranteed minimum and a **9.5%** current maximum.

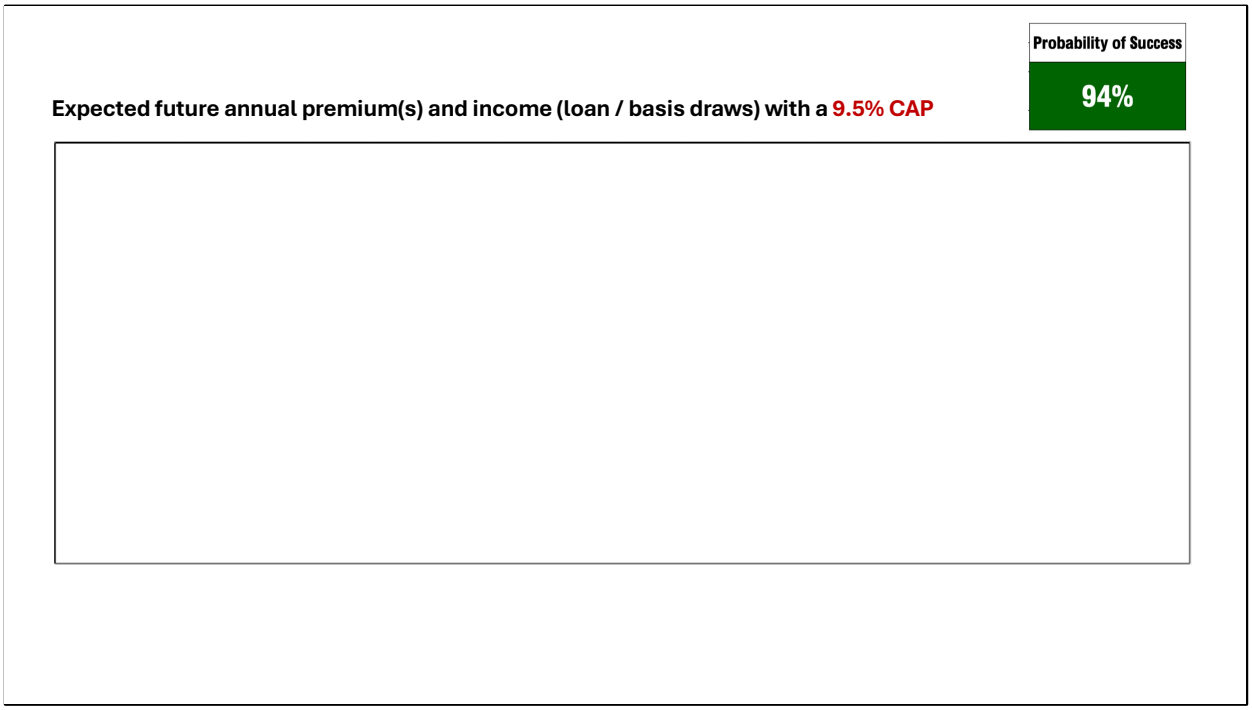


We want to point out that this analysis isn't critiquing the policy itself. It's a "style" of policy design that *could be* appropriate for a client if product suitability is taken into account . Instead, the problem is with the policy illustration.

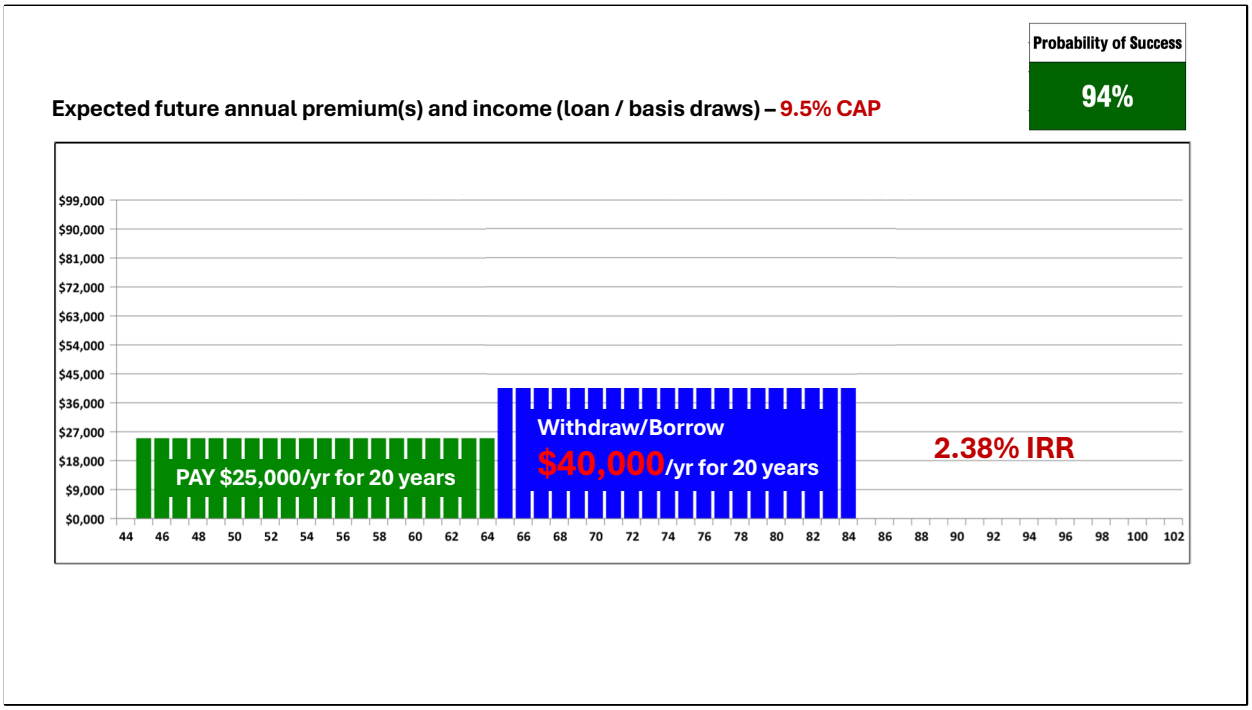
Policy illustrations are NOT THE POLICY – and yet most explanations of "how the policy works" come from a review of the policy illustration. This is especially true for today's more complicated policy styles.

The CFP Code of Ethics requires honesty, integrity, competence, and diligence - acting in the client's best interest – and exercising due care.

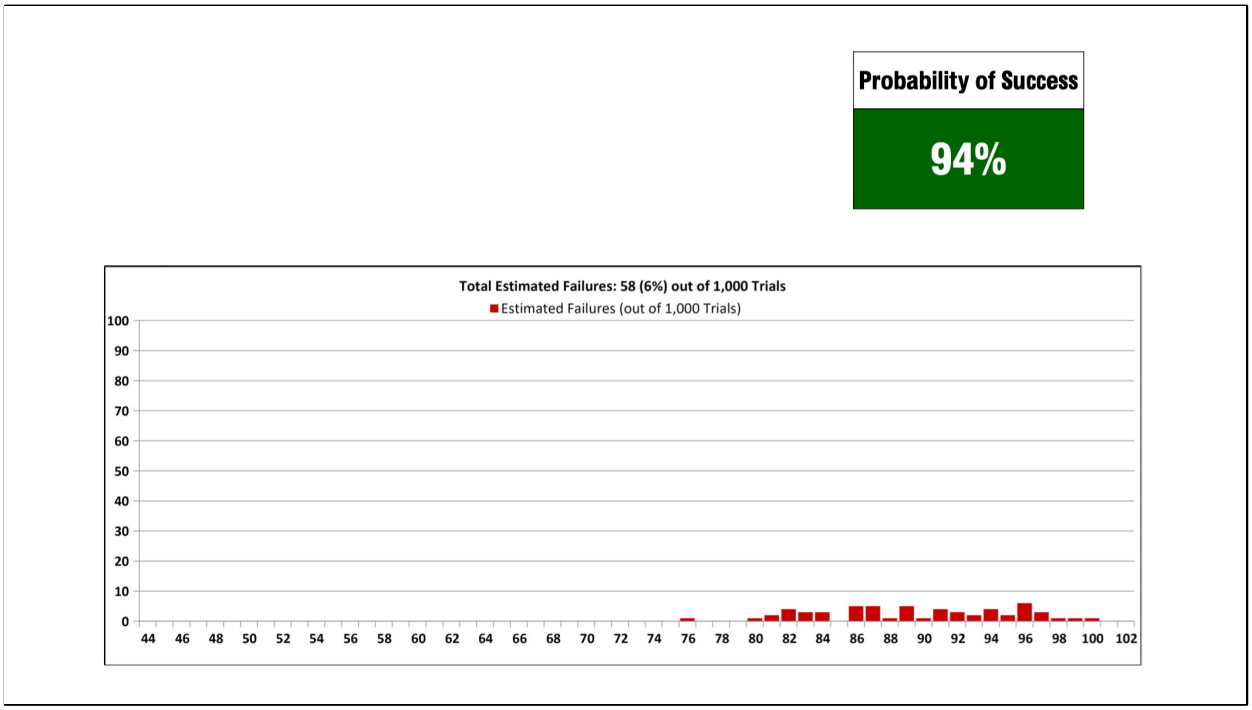
Against that standard, the policy illustration can NOT be used as the means for recommending life insurance products.



To finish this explanation, it's necessary to contextualize the possibility of a lower CAP rate …



... with the resulting expectation of future cash taken from the policy to meet the client's required probability of success ...



... and the need to explain and disclose the statistical incidence of the few lapses that are projected.

An insurance license is not enough!

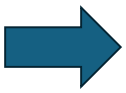
Registered Investment Advisor with an insurance license

Website: “There's a Power in Planning With Us. For over 20 years, we have addressed the financial needs of clients and their families. Our leadership team has over 60 years of combined experience and not only has exceptional skills for managing all aspects of our business, but the right attitude to do so. Utilizing a client service approach and a commitment to lifelong learning, we always put the needs of our clients first, encouraging them to ask questions as we address their needs, together.”

This is the website statement of the Registered Representative holding license to sell life insurance to his clients

Illustration #1

- $320,000 Exchange
- $300,000 x 7 years
- Premium Financing
- Pay off financing Year 12 using policy cash values
- Offered Tax-Free Income for up to 50 years

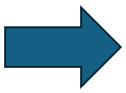


$160,000/year
Ages 70 → 120

The original Sales Pitch called for financing 7 premium payments of $300,000, replacing the 3rd party financing with a policy loan in year 12 and THEN receiving $160,000 a year of "income-ta-free income" for as long as he lived from age 70 to age 120

Illustration #2

- $320,000 Exchange
- $300,000 x **10** years
- Premium Financing
- Pay off financing Year **11** using policy cash values
- Offered Tax-Free Income for up to 50 years



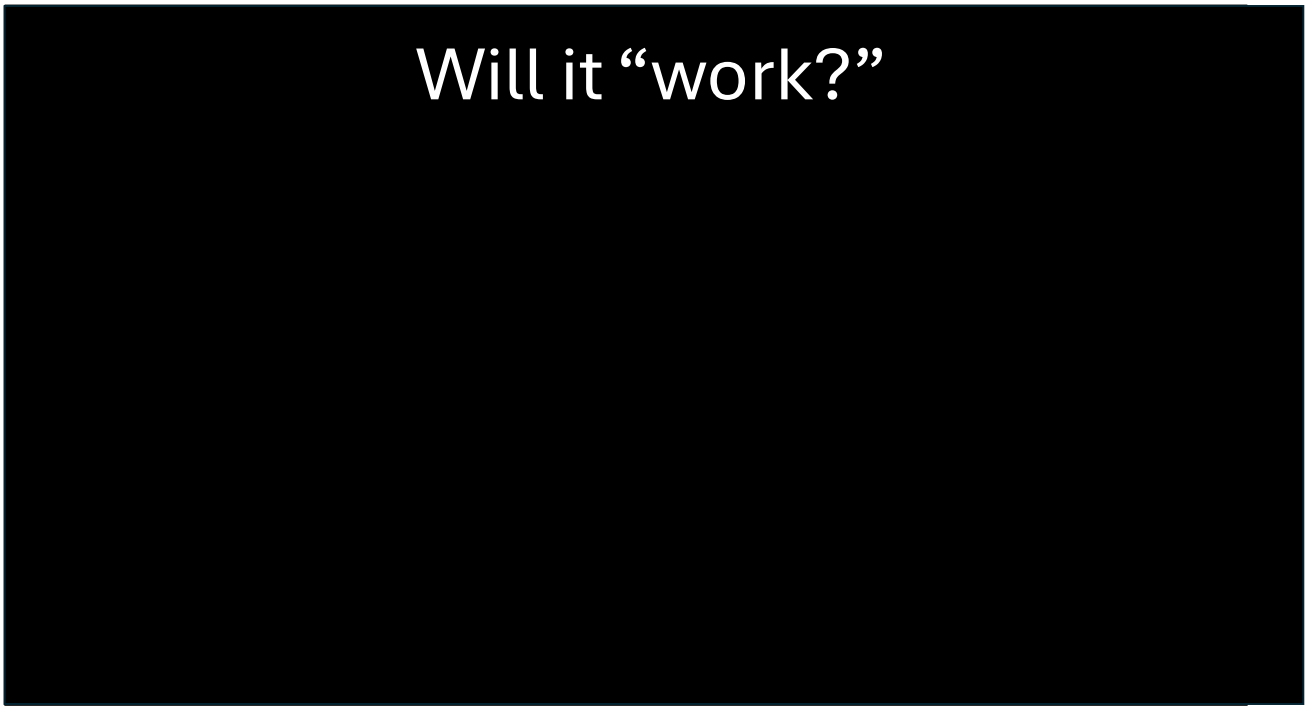
$200,000/year
Ages 70 → 120

"Great news – it's even better!" The scheme expanded the premium borrowing to 10 years – and increased the retirement cash flow to $200,000 a year for as long as he lived

What went wrong?

- Premium financing is premised on the notion of perpetual arbitrage.
- Client was told by the IAR "you won't need to post any collateral!"
- Actual policy credits were only "off" by 10% in 5 years
- Client rarely sees the detailed "Expenses and Credits" illustration
- Values are always growing – the customer never sees the impact of the DEBIT side of "Zero is the Hero"
- A constant illustrated CREDITING scenario is *deceptive*
- An underlying constant CAP or PARTICIPATION RATE is *deceptive*

Will it “work?”



But the question that should have been asked at the outset was “WILL IT WORK?” – not on the basis of a policy illustration that – as it emerges from the laser printer - is already projecting numbers that CANNOT happen

S&P500 | Cap: 10.50% | Floor: 0.00% | Participation: 100%

Monte Carlo Analysis

1000 Trials with Random Crediting Rates

Applying random rates of return within the guarantee and current cap from the customer's chosen asset class

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Monte Carlo Analysis

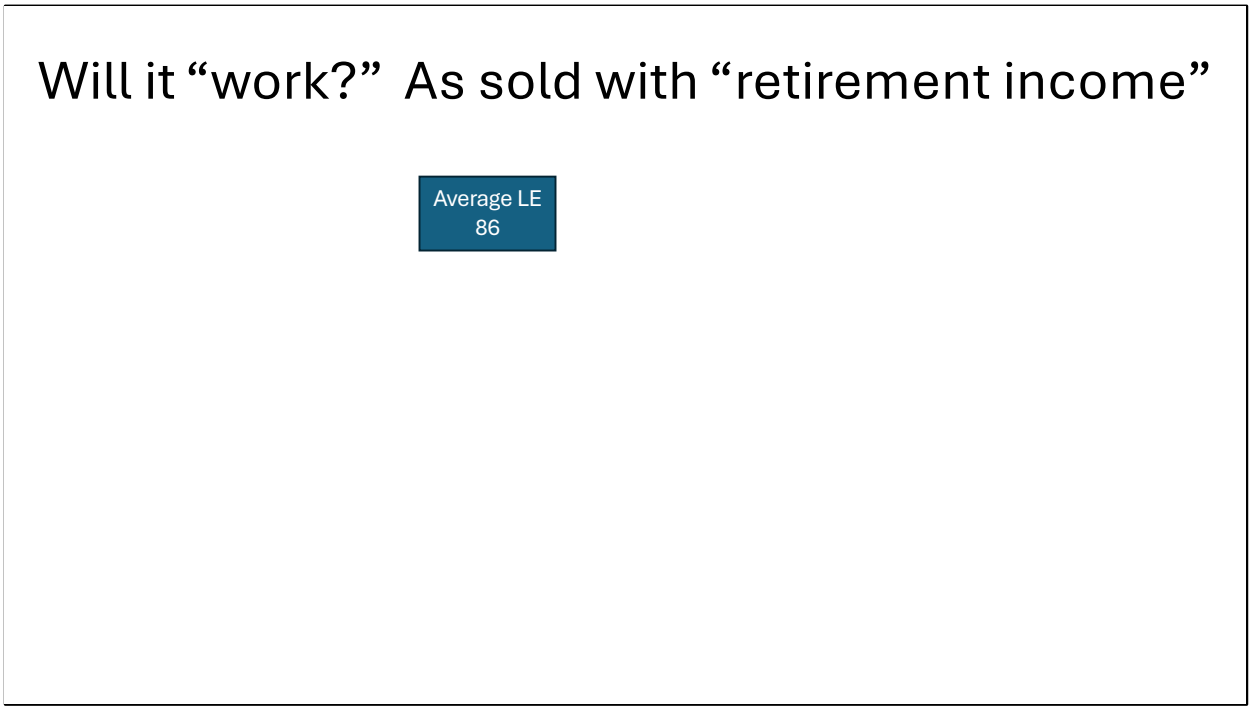
TEST the PROBABILITY $200,000 a year of withdrawals & loans will sustain the policy to at least age 100 *and* "pay off" the external premium loan.

1000 Trials with Random Crediting Rates

Applying random rates of return within the guarantee and current cap from the customer's chosen asset class

And our intention is to TEST the PROBABILITY that $200,000 a year of withdrawals & loans will sustain the policy to at least age 100 *and* "pay off" the external premium loan.

Will it “work?” As sold with “retirement income”



We note the rate class-derived Average LE

Will it “work?” As sold with “retirement income”

With see that with 1000 random hypothetical scenarios, the first one failed at Age 69

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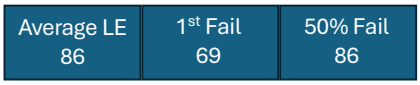
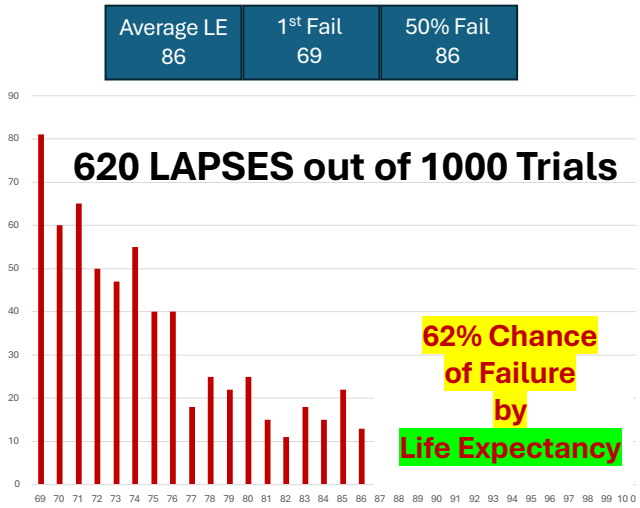


With 1000 random hypothetical scenarios, HALF of all failures occurred at Age 86

Will it “work?” As sold with “retirement income”



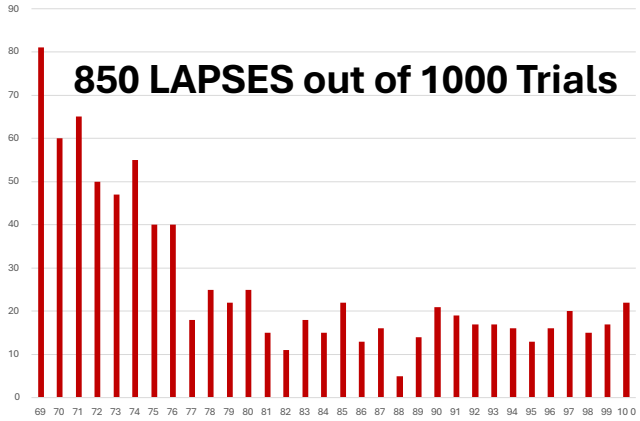
First just calculating to Average LE, we note

- Many of the failures occur at the point of paying off premium financing and transferring the loan to the policy
- The client is never shown “the bad and the ugly”—only the “good.”
- Required “0” / intermediate / current illustrated values are still biased to the “good.”

And a significant dilemma for the policy owner is that withdrawals and loans in excess of the basis will be taxed in the year the policy lapses.

Will it “work?” As sold with “retirement income”

Average LE	1st Fail	50% Fail
86	69	86



85% Chance of Failure by Age 100

And while today’s Age 100 is yesterday’s Age 90, when we run the analysis to age 100, there’s an 85% chance of failure AND tax recapture on everything borrowed from the policy in excess of premiums paid (basis)

This case has been in litigation since 2023

OBSERVATIONS

1. It's not the product ...
it's the ILLUSTRATION

OBSERVATIONS

2. Agents subject to a fiduciary duty cannot use a “Model 582” Policy Illustration for IUL (or VUL) products!

OBSERVATIONS

3. The IUL product will fluctuate more widely from its illustration than other cash value policies. There needs to be a way to convey that in a manner the purchaser can understand and make a buying decision that's in their best interest

OBSERVATIONS

4. With ALL illustrations - no matter the warning - customers will focus on the most favorable illustrated ("current") outcome as a ***projection*** of future values

OBSERVATIONS

5. The future of policy illustrations:

We need to get back to the intention for policy illustrations – "how does the policy WORK?"

IUL illustrations are like trying to explain 3-dimensional chess using a 2-dimensional chess board. We now have the technology to dynamically illustrate HOW THE POLICY WORKS – the original intention of policy illustrations.

And today's "pad" technology is readily available to provide dynamic "WHAT IF?" information to whatever degree the customer may want it.