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Sounding The Alarm On Indexed Universal Life Insurance

By Ed Leefeldt
Contributor

Les Masterson
Editor ✓ Fact Checked

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For more than a decade, indexed universal life insurance (IUL) has been one of the life insurance industry's most profitable businesses. New IUL premiums increased by 29% in the fourth quarter of 2021 alone, according to LIMRA, an industry-funded financial research company.

There are now at least 52 insurers selling indexed universal life insurance, says Barry Flagg, president of Veralytic, a life insurance products rating service. Pacific Life is the biggest and holds about 19% of the market.

But critics say indexed universal life insurance is being sold dishonestly. "They are complex products sold with false promises and deceptive marketing," says Birny Birnbaum, executive

Riding an Index

The cash value within an IUL policy is tied to an index. This might include plain vanilla ones such as the S&P 500 and the Russell 500 indices. But money could be going into more esoteric ones like the Hang Seng, Gold and Emerging Markets.

Options allow the holder to buy or sell the underlying index at a certain price at a certain time, which can rise or fall rapidly. If an option is exercised "in the money," the payoff can be significant. But if the option expires "out of the money," the entire investment in that option is lost. And this is why IUL is a riskier investment than traditional insurance. Critics say that risk is not properly disclosed and is borne by the policyholder.

"Consumers should avoid IUL because the insurers and agents who sell the product have no obligation to work in the consumer's best interest. Mix in massively complex products designed to juice illustrations with opaque and unaccountable features and you have the recipe for future financial disaster," said Birnbaum in a July 2020 statement that warned consumers against buying IUL.

The American Council of Life Insurers (ACLI), which represents 280 companies in the insurance industry, admits that IUL is not for everyone. "But indexed universal life would not be increasing in popularity if millions of long-term planners and families were not finding the cost of owning the product to be a good value," says ACLI spokesperson Jack Dolan.

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Trying to Play It Safe

Indexed universal life insurance is in the same class as other permanent life insurance policies, such as whole life insurance. This means that it won't expire—the way term life insurance will—provided the premiums you're paying and policy account values are enough to keep the policy in force.

Life insurance companies that sell traditional policies like whole life insurance invest primarily in corporate bonds and government-backed mortgages where the money will be safe and generate a small, but reliable, annual return each year.

An indexed universal life insurance policy is different. As the name implies, it takes yearly interest income from the bonds and mortgages underlying the policy and invests that interest in options on one or more indices. These policies are sold by insurance agents as an indirect way to play the options market. The insurance company manages and buys the options, rather than the

It’s a way for life insurance policyholders to have their cash value take part in the market.

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Fees Can Drain the Policy

While it’s true that indexed universal life insurance offers a bigger upside than a traditional life policy in a good year—like 2021 when the S&P index rose 26.9%—and while it can protect against investment loss, the costs associated with an IUL can drain the policy of its value.

To afford the budget for the money management involved in options trading and compensate the insurer and its agent, IUL policies can include significantly more fees and costs than an average life insurance policy. One insurer charges upwards of 8% of the premiums and cash value in the policy in the first year alone, according to Steven Roth, president of Wealth Management International, an insurance analyst and litigation consultant. That’s more than most hedge funds.

These fees threaten to drain your policy’s cash value during adverse periods when the market—or whatever index the policy is tied to—plunges. If internal costs cause the policy account value to

“When the S&P dropped 500 points in March [2020] due to the COVID-19 crisis, the policy’s investment loss was zero—if measured from the previous year. But the monthly policy expenses may have caused losses of several percent in the value of the policy—and if it went down too much —then policyholders got a ‘premium call’ requiring them to put in more money,” says Roth.

Pay Up or Lose Out

If you don’t keep paying the higher premiums to keep the policy in-force, you risk losing all previously paid premiums, as well as the death benefit going forward.

In one example cited by Veralytic, a person could pay $367,000 over six years on an IUL policy and get nothing back if the policy is canceled. When a policyholder tries to surrender the policy, the insurer might keep the entire first year’s premium since it has already paid the commission costs to the agent who sold the policy.

“Policy values in IULs are depressed for many years due to high up-front charges and high surrender fees,” says Roth, adding that, “These typically last for more than 10 years after the policy was taken out.” Roth was recently part of a class action suit against Prudential Insurance Co. involving overbilling and improperly lapsing universal life insurance policies. He is working on another one against Pacific Life over deceptive sales practices concerning the earnings potential of indexed universal life insurance policies.

The ACLI’s Dolan says the size of the premium depends on the returns on the options in the policy. “The fact is, in a different (and better) economic environment, *less* in premiums would be paid than originally planned,” he notes. “Owners of this product must be aware of exactly how it works, because, unlike certain other types of life insurance, IULs have a fluctuating component to them.”

If you don’t have the stomach for investment losses, or don’t have the patience for long-term investing, IULs probably aren’t for you.

The IUL Sales Problem

A little-known rule passed by Congress in 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act exempts indexed universal life insurance from federal regulation. So, IULs are not regulated by the U.S. Securities and Exchange Commission, unlike stocks and options.

Insurance agents typically aren’t required to undergo the same training as stockbrokers to sell so-called “derivative products” such as options based on an underlying index like the S&P 500. Their only requirement is to be licensed by the state as an insurance agent.

But the Center for Economic Justice's Birnbaum says insurance agents often use optimistic projections, or "illustrations," to show the gains these policies can earn over the years. This makes it appear as if the policy will be "costless" in certain years, or you won't need to pay as much into it as other types of life insurance.

The problem is that these projections are not guaranteed, and may not come to fruition. People will buy IUL policies based on a fictional future and hit a hard reality when they have to pay substantially more than they expected in order to keep the policies in-force.

Dealing with the Unexpected

Remember that a life insurance policy may be in effect for 40 years or more and a lot can happen during that time. For one thing, after a few years the insurer may lower the "crediting cap," which is the maximum amount it allows the policyholder to earn on the policy when options do well, says Wealth Management's Roth.

Insurers often use low-cost loans in order to sell IULs, and have lenders lined up to offer loans to potential IUL buyers, he says. This practice is called "arbitrage." In fact, many indexed universal life insurance buyers have been encouraged to buy up to five times the amount of insurance they actually need with these low-cost loans, Roth says. They are led to believe the policy will earn 6% or more each year, and since they can borrow the money to pay the premiums at 3% or less, they think they will make at least 3%, far better than a bank can offer—and on borrowed money.

But the policy owner is likely to have to requalify as a borrower every three to five years, during which time the interest rate may go up while the cash value inside the policy could go down.

So, it's no wonder that IULs are complicated. Birnbaum's Center for Economic Justice obtained a Pacific Life policy that includes 72 pages of legal jargon and many different profit projections—referred to as "illustrations"—making it difficult for the buyer, or even the insurance agent, to understand. Pacific Life did not respond to repeated calls and emails.

What's Wrong With This Picture

A committee of the National Association of Insurance Commissioners (NAIC), which sets the standards for the state regulators who control insurance, has struggled for years to produce guidelines that states can adopt to ensure that the illustrations used by insurance agents to sell IULs reflect the risk buyers take. Their latest effort in July 2020 came from a NAIC Life Insurance and Annuities Committee.

But not successfully, according to Birnbaum. “We defy any member of the Committee to comprehend and explain, so a purchaser of this product could understand how this product operates,” he says in a letter to the NAIC. “Regulators are not doing anything to stop the unfair practices,” he warns.

Opinions about indexed universal life insurance vary, but critics warn that it’s not the riskless investment it may be sold as, and you could lose it all. Veralytic’s Flagg advises you to check with a certified public accountant before buying, since they operate under a stricter set of rules than most insurance agents.

Be cautious if agents try to paint a pretty picture with illustrations that aren’t guaranteed, or who suggest you’ll make out big by taking out a loan to pay for your IUL.

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Leefeld

Contributor

Award-winning investigative journalist Ed Leefeldt's stories have led to changes in credit card practices, voter registration and disability payments to prisoners. He has written multiple cover stories, hard-hitting features and executive profiles for major media outlets, and is the author of The Woman Who Rode the Wind, a novel about early flight.

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