A Preferred Approach When Using Life Insurance for Retirement Income

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Our firm has been presented a number of opinions on indexed life insurance, both favorable and unfavorable. The purpose of this white paper is to sort out some of the claims and present a path forward for advisors who are reviewing, considering, or proposing the use of indexed life insurance for accumulation and future tax-free income.

Whole Life is Not Usually Our First Choice

The claims of many whole life-oriented commentators about indexed universal life may not indicate a full understanding of indexed universal life. A blanket statement that whole life will always deliver better results completely ignores the most important question: which product should be used by different clients with different objectives and different situations. For example, maybe I should purchase a station wagon, but that is not the car everyone else should purchase. With life insurance, not everyone needs their cash values to be guaranteed for the life of the contract, nor do they want to pay for that protection.

Another topic is often raised: company structure. We work with both mutual and stock companies. Good management is more important to us than form of ownership. The way a company is built doesn't necessarily have a direct impact on its product results. In my own background, I saw something like this at work in book publishing. When I worked for Walk Thru the Bible Ministries, I can assure you that how books were priced in the bookstores had nothing to do with whether they were being sold by a non-profit or a for-profit entity. The pricing point was set based on the market. The debate over stock companies, which sell mostly products other than whole life vs. mutual companies, which tend to emphasize whole life, has been with us for my entire career. In every situation it has been brought up to me, it has been brought up by a mutual company representative, a standard part of their training. They are taught every day that mutual companies are good and stock companies are bad. This is really a non-issue, and even more so when some of the indexed products under attack by whole life promoters are issued by mutual companies! Some excellent mutual companies offer both whole life and indexed products.

Few of the advisors we serve have a clear preference between whole life and indexed life. When advisors have a preference, we may offer comments about what the opposite product can do, but we focus most of our time seeking

the right products within the types of policies preferred by the advisor. Advisors always have the final say in what they want their clients to own. Advisors know their clients best. However, most advisors do not have a preference, leaving us with the widest opportunity to assess client objectives and risk tolerance and then seek products that will best serve the client.

Approaching this from a different direction, the whole life debate also focuses on whether a stock-driven interest rate can deliver higher results than a bond-driven dividend. Even though the annual movement of stock prices is generally wider than that of bonds, historical data clearly shows that stock investments should outperform bond investments over time. Good wealth managers know this. It explains why retirement accounts tend to be allocated more to stocks than bonds, particularly among younger clients in the years prior to retirement when building up an account is very important. Let me shift to the products where we see the most opportunity to develop retirement income.

We See Great Promise with Indexed Products if the Risks are Understood and Managed

Indexed life insurance has shown up most often as a universal life policy. The difference between indexed universal life vs. fixed universal life is in the way the interest being credited is calculated. In both contracts, the cash value is increased by premiums and interest rates, and reduced by insurance charges. The interest rates credited for fixed universal life are currently in the range of 3-4.5%, with a floor of 2-3%. Rates can change monthly, but seem to mirror mortgage rates and dividend rates. By contrast, indexed fixed life does not declare an interest rate. Instead, it sets up the circumstances under which the rate will be determined.

How interest rates are determined for an indexed policy is where all of the risk and opportunity lie. A policyowner is typically assured a floor of 0% interest. Then the creativity begins. Most commonly, these products base the interest rate on what happens to the S&P 500 index, without dividends, over a period of one year. The policy is not invested in the S&P 500. It earns an interest rate determined by how the index performs. In the most common approaches, the carrier will credit interest equal to the increase in the S&P 500 Index over one year, limited to a cap rate of something currently in the range of 10%. Thus, if the market goes up by 8%, the carrier will credit the contract with 8% interest. If the market goes up more than 10% in this example, the carrier will credit 10%. Finally, if the market goes down, there will be no interest credited.

There are several variations, and more are being developed on a regular basis. Some contracts have different participation rates, which is the percentage of the S&P 500 Index performance (either less than 100%, 100%, or more than 100%). In exchange for a higher cap rate, a carrier might add a “spread rate”, where no gains under 6% will drive any interest but all gains over 6% will drive the interest crediting rate with no limits on the top side. Also, the index used could be some other index, such as one created by a major financial institution. And the time frame used to calculate a change in the index could be 2 or more years instead of one year.

Like the universe of mutual funds, the features of indexes are virtually unlimited. For this reason, and the relative newness of this product, agents tend to use the one-year point-

to-point S&P 500 Index with a floor of 0% and a cap rate of about 9.5% today. Funds are placed into a one year "segment" and wait for the completion of that year to capture whatever is driven by the change in the index. I used a 9.5% cap rate "today", because cap rates change, just like fixed interest rates change. However, these changes only impact new segments allocated after the change takes effect.

Indexed universal life is intended to deliver a result that is higher than what is expected from fixed rate universal life or whole life. Where the controversy lies is in the illustrations created to show potential future results. The factors and rates we assume control the results of the hypothetical model. So, while the illustrated result accurately reflects the assumptions, it has often been misunderstood as reality, even if it is projecting decades into the future. It is our responsibility to help clients fully appreciate that illustrations are hypothetical in nature and will never occur exactly as shown. What is **illustrated** is simply what would happen under the market conditions assumed.

In my previous work designing retirement plans and in completing and applying the RICP curriculum offered by The American College, I often made estimates of safe rates of withdrawal for retirement income. This work always involved making educated assumptions and often running Monte Carlo analyses for probabilities. Indexed life insurance illustrations that project retirement income can have similar components. What we must help clients understand is that life insurance of all kinds which projects income in the future is not guaranteed. But we can't conclude that projections aren't helpful unless they are guaranteed. Most advisors do not tell their clients to draw only an amount of retirement income that can last to age 100 as if all funds were in guaranteed savings accounts. Clients prefer to take reasonable risk. Indexed life insurance with a zero chance of reduction in the cash value due to a down market can offer such a reasonable risk.

Here's Where We Land

I believe the best approach is to clarify what is being assumed and fully describe the risks involved. You do this already when you manage a portfolio for your clients. You take the amount of risk that is appropriate and place a client's funds where they will perform the best. If you were afraid of all market risk, you would tell your client to just place their funds in a federally insured bank account. Similarly, indexed life insurance can operate more like a well-designed portfolio. Whole life insurance may deliver results closer to those savings accounts. Some whole life policies blended with term can be designed to deliver better results but compromise the very guarantees that attract buyers to the products in the first place. Again, if a client or advisor wants whole life, we can help, but we typically do this by eroding the costly guarantees to deliver the highest possible income.

Understanding Indexed Life Products

The primary ways indexed life can help increase retirement income are the following:

1) **Selection of index**. Most policies base their results on the changes in the price of the S&P 500 Index, without dividends. However, there are several proprietary indexes available including indexes designed by reputable firms, primarily to reduce volatility.
2) **How the index result impacts what is credited**. This can be a simple

cap rate for the highest allowed participation and a floor rate to protect against down markets. It can also be a variation such as "spread", where no gains are recognized until a minimum amount (say 6%) is achieved, and then there is no upper limit. There are also variations in what percentage of the index is used to determine the result. This is called a participation rate. Even more variations will become available on a regular basis.

3) **Multipliers.** For an extra annual asset charge, the result of an index as determined by the above methods can be multiplied by a factor. An example might be that for an extra 2% per year asset charge, the result of the index will be multiplied by 150%.
4) **Indexed policy loans**. Rather than borrowing at a fixed rate and earning a fixed return on that portion of the cash value securing the borrowed funds, policies may offer to loan funds at a maximum rate of perhaps 5.5% and credit the loaned portion of the cash value at the same rate the index delivers. So, if the funds are borrowed at 5.5% but the cash value securing those loans earns 7.5%, the policyowner is creating a 2% positive arbitrage in the result. This also means that loans cost the full 5.5% in a year when the returns are zero.
5) **Bonus interest**. Many carriers offer some amount, maybe 0.1%-0.5%, after a contract has been in force for some period of time. This may or may not be guaranteed.

Again, this list is not complete. By the time you read this article, we are likely to see even more variations in how to come up with attractive interest rates through the use of indexes.

The fact is that all of these options can significantly improve the result of an indexed insurance policy. Most of the options are available for use in any future policy years, allowing the policyowner maximum flexibility to manage the policy to optimize the result. Just like an advisor will reallocate a retirement plan, the advisor can also direct that different indexes be used any time in the future, making frequent changes as needed to fit the planning and market situation. This is far different from whole life where the investment approach is a "one size fits all", delivering to the policyowner whatever the carrier decides to pay based on how it invests its general account, primarily in bonds.

I have no argument with the complaint that the factors impacting the result of a policy illustration can be applied in a way that is very unlikely to occur. For example, almost all illustrations show a levelized average market result, even though the level result will never actually occur, even in a single year. With levelized returns, the illustrations will not normally show any years where there is a zero result. Conversely, the illustrations cannot show any years when the result exceeds the average amount illustrated. This may make illustrations seem too good to be true. They could be, but by being careful to show lower, more conservative results, these illustrations can also show why the indexed approach is very attractive.

The controls placed on policy illustrations are partly the result of what has been demanded by the whole life carriers in the development of the AG-49A illustration rules. Those rates are the result of industry-wide input and agreement

among very diverse carriers. The rules demand the use of a levelized return which does not allow a picture of what would happen in all variations. That is why we show, say 6% level returns instead of a combination of 0-10% returns that averages 6%. I would argue that two years at 9% and one year at 0% would be a much better depiction than showing 6% for all years. So, while we must use level return assumptions, we can still be careful in a number of ways.

Start With a Conservative View

A good practice would be to show a client a very conservative scenario and also show a scenario that more closely fits the client's risk tolerance, especially when the extra risk is fully understood. This will set expectations more realistically and it will implicitly demonstrate how the illustrations are hypotheticals. The client will see a relatively reliable projection but also see a very attractive upside potential.

Given this discussion, I would like to suggest a good approach to illustrating indexed life insurance. While the advisor's preferences control, I believe a good illustration will have the following elements:

1) **Choice of Index** – In order to have the maximum ability to assess historical data, I prefer to show the S&P 500 Index as the benchmark driving interest crediting, not a proprietary index. This allows us decades of history and a known index. That is not to say that the ultimate policy allocations won't be to a different index in an effort to improve performance. I am just starting with a known index, even though I might prefer some of the alternate indexes with some clients.
2) **Assumed Return** – All policies are limited to a unique rate under Actuarial Guideline-49A ("AG-49A"). This is generally the average rate that would have been earned over a large number of years specific to that policy. Since some products have very different AG-49A rates, I like starting with the unique AG-49A rate for each product being compared and reducing it by 20%. A policy with a 6% allowable illustration rate would be shown at 4.8%. Another way to do this when comparing products would be to set all carriers to the same rate, such as 5%. There is a lot more to the comparison used, but I am indicating these two approaches only as simple methods. We often have our own refinements. Of course, the leveraging or multiplier accounts discussed below are not allowed in the first conservative illustration.
3) **Policy Loans** – Taking extended retirement income out of a policy will ultimately require the use of policy loans, either at the beginning of the income stream or after basis has been withdrawn. I like to show fixed loans, which are the most conservative and which do not create arbitrage gains when interest rates charged are lower than the rates credited on the policy. Similarly, we also avoid the use of variable rates, which add another element of unpredictability. But again, that is not to say we won't advise clients to periodically use variable loans when they are attractive at times in the future.

4) **Death Benefit** – Typically, the death benefit will be the lowest possible death benefit that doesn't disqualify the policy from its significant tax features, also known as making the policy a modified endowment contract ("MEC"). Carrier software makes this easy to do by inputting the projected premiums and other factors and asking the software to solve for the minimum non-MEC death benefit. However, if there is a potential for a client wanting to increase premiums in the future, we sometimes will consider using a higher death benefit by some percentage, so that the policy can take in the higher premiums later. The typical alternative of just buying another policy in a future year to absorb premium increases may vanish in the future if the insured suffers a decline in health.
5) **Income at Retirement** – Most software allows for a calculation of the maximum income that can be taken for a selected number of years on a level basis. You might also consider asking for that income stream to start a little lower and then grow by some percentage to allow for inflation. Yes, most carrier software can do that also. Likewise, you can set up the targeted retirement income and have the software solve for the optimal premium and death benefit.

There are other less obvious variables, which we will use, but they are our personal preferences which go beyond this discussion. Ultimately, this will deliver a reasonably good illustration of what an indexed policy should be able to deliver to your client. It becomes our base illustration both for comparative purposes among the selected carriers and for reasonable income planning assumptions.

Now It's Time for the Upside Possibilities

Then, we can have a little more fun and design something that shows what the policy could really do under more optimal circumstances. With a better understanding of the individual client's risk tolerance, here is what that 2nd illustration might add:

1) **Choice of Index** – There are newer indexes that should deliver better results for a number of reasons. They may offer some additional volatility protections and higher projected results. They would also help diversify policy allocation away from 100% to the S&P 500.
2) **Leveraging** – If a client is very positive about how well indexes can perform, we might want to show what a higher participation in the index could do for the policy. Some policies give owners the ability to buy a multiple of the basic result. This is done by adding an extra charge to the cash value of maybe 2-7.5% in future years at the election of the policyowner. That money is used by the carrier to buy more options and expand the range of results. For example, instead of receiving interest with a minimum (floor) rate of 0% and a maximum (cap) rate of 9.5%, the range would be expanded to a floor rate of -2% (due to the cost of the extra options), and a maximum return of

1.5 times the 9.5% cap rate, or 14.25% (minus the 2%), a 12.25% net result. This client would have a wider range of -2% to +12.25%. In the circumstance where the index goes up by 9.5% for two years out of three and down one year out of three, the results would become 12.25, 12.25, and -2. That's an average of 7.5%. The key thing to understand is that the policyowner is buying a multiple of the index, not the actual additional options. What options are purchased remains the problem for the carrier to face so that it can cover its promises.

3) **Indexed Loans** – Some clients may fully believe that equities should return more than 5.5% over the long term, which can be the guaranteed rate for some indexed loans. Under these circumstances, if funds are borrowed at 5.5% but credited back the leveraged result just described, then funds borrowed at 5.5% could earn 7.25% net, a 1.75% positive arbitrage. If that really happened all of the time, you would borrow everything you could out of one of these contracts! Note, however, the rules of insurance illustrations don't allow for the illustration of anything over 0.5% for the arbitrage. To put this another way, the reality could actually be much better than what the regulated illustration shows.
4) **Aggressive Strategies** – There are other strategies that can be employed for clients with a higher risk tolerance. Clients wanting to maximize what is offered by indexed life can be shown these arrangements on a case-by-case basis. These designs show significantly more income, but with additional risk. My sense is that these designs would probably be suitable for maybe 20% of the affluent clients we serve.

Let me share a final thought on the use of leveraged options. In my example, I posed the situation where the upper end of results might reach 12.25%. In fact, there are uncapped leveraged approaches that we have seen deliver results of 28%-35%! This has occurred in just the last few years amidst a volatile market scenario. The challenge with these approaches is that they cannot be illustrated, even though they happen under real market conditions. Rules for the maximum level illustrated rate (the AG-49A rate), do not allow these results to be projected. As a result, illustrations with or without leverage can end up being quite similar. Ultimately, if an advisor likes leveraging, he or she will still use it. The difference is that it will show up in actual results, regardless of what AG-49A forces in the projections.

Glass Half Empty or Glass Half Full?

Overall, through the extra effort of building alternate illustrations, the advisor will have two very different pictures – and they can be for the same product! The client should rely more on the conservative approach to compare products and build expectations, but he or she can look to making the more creative approach a reality in the years ahead. We know that interest rates will change, indexes will change, cap rates will change, and stock markets will experience good years and bad years. It is critical that owners of these products understand that they need to play an active role, just as they are doing with their 401(k)'s or other portfolios. Regular

reviews and adjustments are common to most good retirement planning. What's most important is that the advisor will be assisting the client in the development of what could be critically important tax-free income and a valuable death benefit, both of which will support their financial plan in a significant way.

Ultimately, indexed life offers a platform to grow funds without reportable income and draw out funds also free of tax reporting on a regular or as-needed basis. How funds grow and how they are withdrawn are open to a wide variety of conservative and aggressive choices by the policy owner. The initial policy illustration is a helpful picture of what is possible, but it is far from a predetermined result.

But Wait, There's More

Finally, and perhaps the most exciting development of these products is the addition of indexed accounts onto the list of choices inside of **variable universal life products**. Given all that is possible with indexed arrangements, it is an entirely new world when the policyowner can now add perhaps 50-75 mutual funds to the list of cash value allocation choices. When either a fixed option or an indexed option are not as attractive as stock or bond funds, the ability to jump back and forth is the ultimate flexibility. To all of the detractors who say that index cap rates can't possibly remain attractive in the future, variable products give policyowners a place to go. I see the variable chassis as the ultimate place to accumulate funds and then convert those funds to an income. The variable policyowner has tremendous flexibility to adapt to changing markets. With variable life, the contrast against whole life is even more stark. The whole life policyowner will always be trapped with whatever results a single insurance company can earn out of its very conservative general account and then distribute after company expenses in the form of not-so-transparent dividends.

The Verdict

We believe that indexed universal life insurance, and the newer variable policies with indexed funds represent an excellent approach to building retirement income. I won't compare the results to a typical portfolio of investments. That requires a longer discussion about allocations and assumptions. But I can say that the tax advantages with properly structured life insurance policies are enormous. For the right client, the use of indexed life insurance is a strategy that must be considered. It can often be the perfect complement to traditional funding with qualified and nonqualified plans.

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