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Introduction to Private Placement VUL

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The Market

Many companies have been moving to offer private placement variable universal life (PPVUL) policies. Some entering this market are U.S.-domestic companies, while many are located in far-flung exotic lands around the globe. The issuers range from the largest multi-line carriers to the smallest offshore independents, but they are all drawn to this market by one thing: the potential customers are wealthy U.S. taxpayers with sizable onshore and offshore assets. This group is the holy grail of marketing executives — the high-net worth market.

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What do these customers want?

- They are looking to place enormous amounts of money into these policies. These amounts are high enough to push up against the maximum amounts of life cover available in the reinsurance marketplace.
- Their funds should be accumulating on a tax-deferred basis, and must thereby qualify as life insurance under the U.S. Tax Code.
- They want the policies to be issued in a jurisdiction where separate account statutes protect the cash values from the insurer's bankruptcy.
- They want the values to be held in U.S. dollar denominations.
- Some want offshore assets to stay offshore, maintaining their existing protection from U.S. creditors.
- Finally, because of who they are and the amounts involved, many expect to negotiate the cost to obtain the best possible deal.

These buyers are drawn to PPVUL, issued either as a modified endowment contract (MEC) on a single premium basis or with limited payment periods to produce a non-MEC. Because of the sophisticated nature of the purchasers, the policies are sold as private placements, allowing unique investment instruments that may be provided on a policy-by-policy basis and avoiding SEC registration.

Naturally, this market is not reached through normal distribution channels, but through high-level agents experienced in providing the level of personal service to which these high-net-worth individuals are accustomed. But, reaching these potential customers means satisfying their personal advisors, with whom the agents often have existing relationships. Finally, this level of service must continue after issue.

Onshore vs. Offshore

The offshore companies have certain advantages, primarily freedom from state regulation and neither premium nor federal income taxes for the company to pay. More and more domestic companies are choosing to offer PPVUL without these advantages, with good reason. Onshore distributors have the advantage of being able to market their products directly to U.S. customers while their offshore counterparts must struggle to market and issue policies while remaining offshore and avoiding being drawn into U.S. regulatory jurisdiction.

Simplicity

For policies with jumbo face amounts, the sources of profit are simple to identify, especially because the buyer will attempt to negotiate everything down to cost. Actual taxes and compensation, if not paid directly by the customer, may be charged directly as premium loads. Per policy charges may include an at-issue charge to cover acquisition costs plus a recurring fee for marginal administration expenses. Because the policy sizes generally far exceed the maximum retention limits, the cost of insurance is generally equal to the reinsurance costs, plus a very small margin.

That leaves the per asset charge (often called the M&E) as the primary source of profit. This provides an ongoing profit stream as dependable as that on a variable annuity. Consider that a meager M&E of 40

basis points applied to single policy with $25 million of net premium can generate $100,000 annually for the company (assuming a constant account value).

It is easy to see that even only a few sales are sufficient to make this a profitable line of business. It is also easy to see why the customer feels empowered to negotiate the lowest cost product, trying to reduce the per premium and COI charges to cost and minimizing the M&E.

Compliance

Because the policyowner is a U.S. taxpayer, the policy must be in compliance with the definition of life insurance under Section 7702 of the Internal Revenue Code. This requires that the policy be considered life insurance under applicable state (or local) laws and that it satisfy either the Cash Value Accumulation Test or the Guideline Premium/Cash Value Corridor Test, of which most VUL policies are issued under the latter test. Furthermore, there are rules regarding minimum asset diversification and investor control to be satisfied.

The primary measure of competitiveness is internal rate of return (IRR) on surrender. That is, the objective is to minimize total charges and still qualify as insurance under U.S. tax code. As a result of the customer's empowerment in this market, every issuer has already reduced the relative level of charges to near cost.

How else can charges be reduced? Because many of the buyers are focused on the cash value, it makes sense that the policy could be made more competitive if there were less need for insurance and its associated cost. That is, a lower face amount would result in a lower net amount at risk, producing lower insurance charges and higher cash values.

These policies are generally issued at the minimum face amounts that will satisfy the Guideline Premium Test under IRC 7702 for the given premium level. Although these provisions of the code were made effective in 1984, final regulations for them are still pending, leaving many open questions. The domestic life insurance industry has, over the years, reached some broad consensus on how to calculate guideline premiums, but there is still a range of interpretation because some companies are careful to be conservative in uncertain areas. Some

companies may choose to utilize less conservative approaches that produce higher guideline premiums, resulting in a lower minimum face for a given premium. In this way, those companies compete by offering the lowest face amount and thereby, the highest IRR on surrender.

For non-MEC policies, the premiums are spread out over several years, increasing the net amount at risk. The purchase of a non-MEC is making a trade-off, linking liquidity without tax penalties with lower overall returns.

Some may choose to reduce the long-term cost of a non-MEC by a substantial face amount reduction sometime after the seventh policy year when no future premiums are planned. The reduction is done once the cumulative guideline level premiums exceeds the actual payments and produces a future guideline level premium of zero. This can reduce the insurance cost in later durations as the COI rates rise to more substantial levels.

Liquidity and Timing

Another factor unique to this market is that the underlying investment options may provide for very limited liquidity. The qualified investor in these private placement products is drawn by dynamic hedging strategies and other funds that may not offer the daily liquidity required by publicly traded mutual funds. In fact, there may be an advance notice requirement for any transfers or withdrawals.

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Under both the Guideline Premium and Cash Value Accumulations Tests of Section 7702, the minimum death benefit is a multiple of the cash value. But on what date is the death benefit determined? Limited liquidity may result in policy values that are not determinable on an everyday basis. One interpretation is that the policy value on a given day is the value that is eventually paid if a surrender were requested on that day (without regard to surrender charges and policy loans). So the policy may be written such that the death benefit payable is based on the value at the next possible surrender date following the date of death.

But, what if a death is not reported immediately? Typically, the death benefit is determined on the date of death and that amount is payable (with interest) once proof has been received. For a variable life policy, any investment gains or losses on the separate account between death and notification are absorbed by the company. Because this risk is not subject to anti-selection, and is spread over many relatively small policies, it is an acceptable risk.

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But when the account value of a single policy may eventually exceed $50 million, even one month's investment shifts may exceed a company's risk tolerance. Therefore, the timing between date of death and notification may create unacceptable financial risks. Some companies may not have addressed this risk in their policies while others have solved this concern in policy provisions or reinsurance to transfer this risk to the beneficiary or reinsurer.

Limited liquidity also complicates processing of recurring charges. Some companies require that the investment managers maintain some level of liquidity to cover these monthly charges. Other companies address this difficulty by using a "liquidity" account that is constantly kept at a level sufficient to pay the next few months' anticipated charges, or simply by accumulating overdue amounts and withdrawing them at intervals.

Reinsurance and Administration

Jumbo death benefits of $25 million or more exceed the retention of even the largest direct issuers. PPVUL mortality risks are generally reinsured on a term basis, where the actual policy COIs are derived from the reinsurance charges. It is important that any reinsurance treaty coordinate the reinsurance with the policy benefits. For example, if the COIs are deducted at the beginning of the month, a death during the month may result in the minimum death benefit determined at the end of the month. The reinsurance should be designed to cover the actual death benefit.

Finally, the company has to track any policies it sells. Even established offshore market entrants may have never issued a 7702-compliant life insurance policy. Some have specialized in annuities while others have not previously focused on the U.S. taxpayer as a potential customer. While the administration of a VUL policy is difficult enough, the 7702 and 7702A issues add significantly to the problem. For the offshore issuers, it is necessary to keep all records offshore and out of U.S. jurisdiction.

U.S.-based companies typically have the experience with domestic VUL products and may utilize in-house systems or onshore TPAs. The limited liquidity resulting from the private placement investment options will result in unique problems to solve. Offshore companies may approach the problem from different directions. Some are using offshore TPAs, who may be associated with U.S. companies with experience in these issues. In-house administration may involve purchase of an off-the-shelf system, development of a home-grown system or a shoebox administration. For those companies who expect never to sell more than a few policies, the approach may not be unreasonable provided sufficient documentation is kept and if their work is supported by calculation programs that fill in the more difficult values.

Conclusion

There are definite opportunities for profitable sales in the private placement VUL market, but these sales require the issuer to face many challenges. As this market grows, only those who have properly addressed the regulatory, marketing and administrative issues will succeed. ☐

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