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Death-Benefit-Focused UL

by Michael Joseph Burns

Universal life (UL) is back— back in a big way. After years of taking a back seat to variable universal life, the industry has seen resurgence in UL popularity. While the recent attractiveness of UL is certainly a reflection of changing consumer attitudes, UL may very well not be enjoying its current success without redefining itself. Not so long ago, UL was a product measured on current performance and cash accumulation, touting the advantages of flexibility, unbundled charges and explicit interest rates.

Today, UL is very much a market-focused product. Some products are designed to have high early cash values. Others are structured to offer low early cash values. Still others place little or no emphasis on cash values and instead focus on low cost, guaranteed, lifetime death benefit protection.

All of this market segmentation has created great opportunities and new challenges for the product development actuary. Clearly each policy needs to be evaluated and priced in a manner that is consistent with its marketing intent. There is perhaps no better example of this than the death-benefit-focused UL—now currently enjoying so much market success.

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The Death Benefit Focused UL

The death-benefit-focused UL is the result of a product evolution that came into emergence during the mid- to late- 1990s. It is an industry solution for the consumer need to have cost-effective, guaranteed, lifetime death benefit protection. Today, this type of product is very common in the market and is a key product for well over 20 UL carriers.

The typical death-benefit-focused UL is structured with a secondary guarantee and some form of maturity extension. A secondary guarantee is a policy provision that essentially provides assurance, that as long as sufficient premiums have been paid, the policy will not lapse; irrespective of the ability of the cash value to fund the insurance charges. Maturity extension is a means by which a company allows a policy to stay inforce upon the insured's attainment of age 100 (the typical maturity age for a UL policy). Combining these two elements, a UL policy can be structured to provide competitively priced guaranteed lifetime death benefit protection.

In providing for secondary guarantees, companies have essentially migrated to one of two structures: the premium-based structure and the shadow account structure. The premium-based structure provides a secondary guarantee as long as a specified premium requirement has been satisfied. The shadow account structure provides a secondary guarantee as long as the net shadow account is positive (where the shadow account is a hypothetical cash value determined using UL processing mechanics and a basis specified in the shadow account provision).

When Regulation XXX became effective in 2000, the premium-based secondary guarantee structure was already fairly common in the market and therefore explicitly reflected in the regulation. The same was not true for the shadow account design, however, which was introduced just prior to the introduction of Regulation XXX. Policies that incorporated a shadow account design could hold a lower reserve than policies designed with a premium-based secondary guarantee when funded at a comparable level. The sections of Guideline AXXX that address shadow account designs were developed with the intent to level the playing field. Now the Guideline AXXX (which became effective January 1, 2003) has seemingly eliminated the reserve advantage that the shadow account design offers over a premium-based structure—the question arises: how will companies respond?

In terms of coming to grips with the new reserve requirements of AXXX, companies can certainly hold the higher AXXX reserves or utilize offshore (financial) reinsurance to provide some reserve relief. In addition, given that the reserve impact of Guideline AXXX varies depending on the policy funding level, companies can control the impact of the additional AXXX reserves by managing the sales volumes across the various funding levels. While there is a cost (whether real or implied) to the reserve impact of Guideline AXXX, recent product offerings suggest that Guideline AXXX will not have a dramatic impact on the market pricing of secondary guarantees.

There is no right answer as to which is the better secondary guarantee structure, as each has its own unique advantages and disadvantages. In many respects, a premium-based structure is easier for the consumer and agent to understand. Because the typical premium-based structure is normally an offshoot of standard "no-lapse" processing, it is often times easier to implement in an administration system. Offsetting these advantages are the disadvantages that such designs have in adapting to certain elements of UL flexibility such as face amount increases, death benefit option changes and additions of riders after policy issue. While the shadow account design is somewhat more difficult for a policyholder to understand, it is much more accommodating to the elements of UL flexibility. It therefore seems clear that the market will continue to see both structures (even in a post-AXXX world).

Pricing Challenges

While the financial impact of Guideline AXXX is real, it is but one dynamic, posing challenges for the pricing actuary in developing a death-benefit-focused UL. The following is a brief outline of other factors that are at the forefront of those facing the product development actuary in this arena. These challenges apply equally to the premium based and shadow account structures.

- Continued commoditization of the secondary guarantee premium. As the secondary guarantee becomes more and more of a commodity, the pressures to reduce price have increased. It goes without saying that this price pressure will impact profit margins, but in the case of such policies, it will also add to the relative level of risk assumed.

- The impact of "locking-in" pricing factors imbedded in the secondary guarantee. While the primary policy guarantees can provide temporary protection against adverse deviations in the pricing assumptions, the company is still at a long-term risk for the protection provided under the secondary guarantee. This "locking-in" makes it critical that the actuary fully understands the reasonableness and appropriateness of the underlying pricing assumptions.

- Risk exposure to changes in interest rates. Given that today's UL market is dominated by portfolio-based products, the death benefit focus for this type of product calls into question the degree of disintermediation risk and excess lapses relative to a traditional cash accumulation UL. However, a long-term pattern of low interest rates can result in spread compression and future losses as the policyholder realizes the full value of the secondary guarantee.

While these are just some of the challenges facing the actuary in developing these products, it is clear the product is here to stay. As the market matures, successful companies will need to utilize some new tools in order to stay competitive. What was once a routine exercise in pricing a standard UL policy will continue to evolve into an intensive process focusing as much on the risk of a product as its underlying static profitability. With such tools as stochastic pricing, evolving reinsurance solutions and sophisticated policy management tracking, the continued development of the death-benefit-focused UL will be anything but routine. ☐

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