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UL Secondary Guarantee – A Rebirth of Fixed Life?

by David W. Simbro

Editor's note: This article is based on David's presentation at the "Rebirth of Fixed Life Products" session at the Product Development Actuary Symposium last June.

Has a "rebirth" occurred in the fixed-life product marketplace, in particular with UL products with a secondary guarantee (SG)? The answer to this question depends, in part, on one's interpretation of the word rebirth. Rebirth is commonly defined as a reincarnation. This might imply that the old form of fixed life product (traditional permanent life insurance) is no longer with us. This has obviously yet to occur. However, it is true that secondary guarantees have many characteristics of traditional permanent life insurance, while having come to life in a different form. To better understand the rebirth, it is valuable to contrast the two types of fixed life products.

UL with secondary guarantees is a UL product that includes a guarantee that coverage will continue uninterrupted, either until a specified attained age but more frequently until death, if certain premium commitments are met, even if the policy's account value is exhausted. My company, Northwestern Mutual, has not introduced such a product, so my view represents an outsider's view.

Lifetime guarantees aren't new. Traditional permanent insurance policies have a lifetime guarantee. What distinguishes UL with SG is first, the relatively low required premium commitment and second, the possible lack of any nonforfeiture (cash) value even if the premium commitment is kept.

A few quick examples demonstrate the low required premium commitment. The average required annual UL/SG premium (with a lifetime guarantee) for three respected companies, for a 65 year old male, best class, is roughly $21 per $1000 of face amount. In Canada, interestingly enough, the same three companies sell Term to 100, (which is less valuable because there are never any cash values and the coverage expires at age 100), for an average premium of roughly $29 per $1000. The 2001 CSO 4 percent net annual premium (payable to 100) is $36; 1980 CSO 4 percent net annual premium is $46. Of course, net annual premiums can be calculated on more favorable assumptions. The net annual premium (payable to 100) using 60 percent of 2001 CSO and 7 percent interest is $21 per $1000.

With interest rates today at such low levels, UL/SG interest crediting rates are such that many current illustrations produce account values that do not reach $1000 per $1000 by age 100, while account values on guaranteed assumptions frequently fall to zero after just a few years—even if the required premium commitment is kept. This is quite different from traditional permanent life insurance. Whether UL/SG policies are "lapse-supported" or not has been a matter of some actuarial debate. However, using any reasonable assumptions as to interest and mortality, there is no doubt that after many years of premium payments, the present value of future benefits (if the premium commitment is kept) can far exceed the present value of the required premium commitment. If a company can extinguish its obligation to pay the benefit, while incurring only a minimal nonforfeiture cost, if any, it will be a favorable economic event for the company.

I have been told by people who should know that a common long-term lapse assumption for UL/SG is between 3 percent and 4 percent annually. This means that after just 20 years, more than half of all policyholders would have lapsed their policies, and overall 2/3 to 3/4 of policies would generally be assumed to lapse without payment of a death benefit. Because UL/SG products are often sold in the estate market, and because of the existence of life settlement firms, it is very possible that lapse rates on these products could end up being quite a bit less. If this occurs, this may lead to a rebirth of another sort. Previously the insurance industry has suffered when it has counted on a certain level of lapse rates in the pricing of its products (e.g. tontines, earlier versions of Canadian Term to 100, and, most recently, long-term care).

Another example of UL/SG taking on a different form is with reserves. Traditional permanent life products have reserves held at a level sufficient to fund future benefits, based on reasonably conservative assumptions. UL/SG products, however, may generate reserves at much lower levels. Creative uses of shadow accounts and/or the use of financial reinsurance can produce reserves significantly lower than the reserves for traditional products offering the same death benefit guarantee, effectively creating a reserve "discount" to recognize assumed lapses and more aggressive mortality assumptions. And so we have actuarial seminars teaching how to minimize reserves on UL/SG products.

Will the rebirth of fixed life products via UL/SG work financially for insurance companies? Insurance companies are paid to take risks. Whether the prices they charge are sufficient for the risks they take can only be known over time, as experience unfolds. All that an outsider can say about the risks inherent in many of these products is that they appear to be considerable. The low premium levels can be justified using an infinite number of combinations of mortality, interest and lapse assumptions, but to the extent they are justified by a consistently favorable view of mortality (low), interest (high) and lapses (high), companies increase their own risk of not being fairly paid. ☐

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