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A Brief History of Universal Life

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Editor's Note: The following article is an extract from a revision to the Universal Life Study Note

Mr. Dinney's 1971 Address

The concepts underlying Universal Life are not new. Universal Life's two major components, term life insurance and an accumulation fund, have been available for years. The idea of packaging these two components together has also been considered before. G.R. Dinney in his 1971 presidential address to the Canadian Institute of Actuaries, entitled "A Descent into the Maelstrom of the Insurance Future," warned of trouble on the horizon for the insurance industry and described a product called a "Universal Life Plan."

Mr. Anderson's "Cannibal Life" Article

When Mr. Dinney delivered his address, the social and economic changes that he was responding to were still going on and their impact upon the insurance industry was still uncertain. By 1975, the effect of these changes had become more apparent to some in the industry and prompted James C.H. Anderson, president of Tillinghast & Company, to define further "The Universal Life Insurance Policy" in speeches and articles.

Mr. Anderson warned that social instability and change were making traditional whole life insurance irrelevant to the needs of large segments of the market. Members of an increasingly informed and cynical public were being pressed by inflation and mounting taxes into reevaluating all their financial commitments, including their life insurance programs. Frustrated by whole life insurance's clumsiness as a financial instrument and doubting its ability to keep pace with inflation, many traditional customers were opting for term insurance combined with an investment program utilizing some other savings medium. Thus, life insurance companies were in danger of losing their share of the investment dollar.

Furthermore, those policyholders who retained their whole life policies were exercising the policy loan provision more frequently, creating cash-flow problems and forcing the companies to invest in these low-yield policy loans rather than the much higher-yield investments available.

Mr. Anderson argued that, to escape their quandary, life insurance companies must turn these social and economic changes to their own advantage. As more and more married women went to work, family incomes rose, increasing the need and ability to pay for family security products. Furthermore, this increased income combined with inflation, was pushing taxpayers into higher and higher brackets, thereby increasing their appreciation of life insurance's tax advantages. Mr. Anderson urged the marketing of a Universal Life insurance policy that would be flexible enough to serve the more sophisticated investment needs of a rapidly changing clientele while retaining the tax advantages of traditional whole life insurance. This new policy would combine "a flexible premium annuity with a monthly renewable term insurance rider." Such a policy would give its owner the term insurance that was needed and wanted. It would also allow participation (through the insurance company) in an investment program capable of dealing not only inflation but also the increasing income tax rates.

To illustrate the competitive marketing edge of such a policy, Mr. Anderson described the hypothetical Cannibal Life Insurance Company. Using an aggressive advertising campaign and supported by activity consumer groups, Cannibal Life begins converting its own and other companies' whole life policies into Universal Life policies, soon capturing a large share of the market. Other companies note Cannibal Life's success and begin issuing Universal Life policies of their own. Attempts by purveyors of whole life policies to halt Universal Life's lower per-dollar commission rates lead to a restructuring of the distribution system, which greatly increases its efficiency and lowers its cost to the investor, further increasing the competitive gap between Universal Life and whole life. Finally, all companies either begin offering Universal Life or withdraw from the market. Market shares and distribution systems within the industry change dramatically, and the industry's share of the individual savings market increases to record levels.

Universal Life Introduced and Established

Early attempts to market Universal Life policies fell short of Mr. Anderson's optimistic prognosis. The early Universal Life policies were structured as a combination of a term life insurance policy and a deferred annuity. The death proceeds paid out of the annuity contract created federal income tax problems for the beneficiary. Attempts to market this predecessor version of Universal Life in 1977 and 1978 also lacked Cannibal Life's aggressive promotion campaign and were not successful.

In 1979, Life Insurance Company of California (later E.F. Hutton Life and now First Capital Life) combined the two elements into a single contract originally called Total Life and later called Complete Life. A few small companies followed the lead of Hutton in 1980, and 1981 saw the entrance of major companies into the Universal Life market. By the end of 1983, nearly all major insurers had introduced at least one Universal Life product, and many offered more than one version. In addition, the passage of the tax acts of 1982 and 1984 served to resolve a few remaining issues clouding the future of Universal Life, and universal Life became an established product.

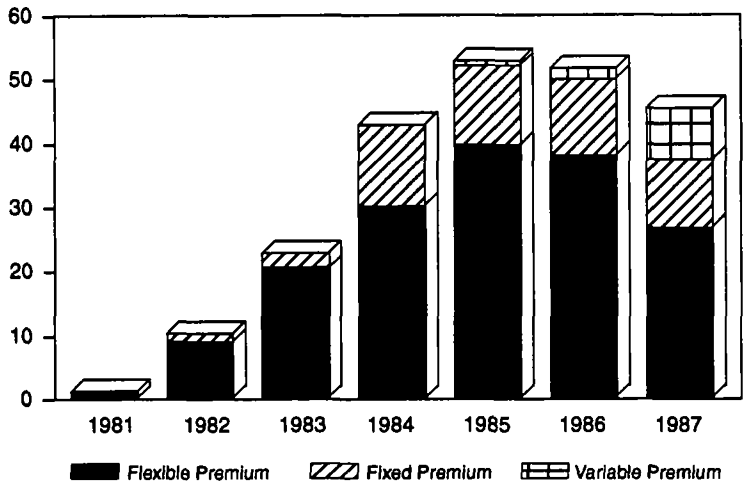
The market share of Universal Life by issued premiums, according to the Life Insurance Marketing and Research Association (LIMRA), grew rapidly in the early 1980s and then shrank somewhat.

The massive increase in Universal Life market share through 1985 was the result of several factors. The most significant is that the interest rates credited on Universal Life products were significantly higher than those implicit in nonpar traditional life products and those embedded in the dividend scales of par life products.

A significant portion of Universal Life sales in the early 1980s were replacement of in-force policies, because the high interest rates of the era made replacements appear very attractive. Many companies even introduced programs to pay agents part or all of a first-year commission for replacing their *own* business (believing that otherwise the business might be cannibalized by other companies).

By 1985, Universal Life sales had largely displaced sales of nonpar traditional life products, except those sold at smaller face amounts and in niche market situations. The surge in replacements began to taper off. Par life products had largely "caught up" with Universal Life interest rates. (Universal Life credited rates had decreased because of the decrease in overall interest rates, and par product dividend-scale interest rates increased as low-yield old assets were rolled over into higher-yield assets, and as dividend-scale interest rates were split into policy-loan and non-policy-loan components.) In addition, some large mutual companies added flexibility to their par products by allowing combinations of whole life, term and paid-up additions purchases, which permitted the equivalent of flexible premium payments.

In 1988 and 1989 flexible-premium and variable Universal Life products had about the same market shares as in 1987. LIMRA did not report a separate market share for fixed-premium Universal Life but included it as part of the "traditional permanent insurance" statistics. So it appears that Universal Life, characterized by a retrospective accumulation of cash values, is well into the process of transforming itself into a respectable "orthodox" product.



Postscript to "Cannibal Life"

Mr. Anderson's Cannibal Life scenario partially came to pass, but not to the extent predicted. In particular, the restructuring of the life insurance distribution system did not take place, because companies effectively transferred the existing compensation structure over to the new product. The industry's share of the individual savings market has apparently not been significantly affected by Universal Life, although it could be argued that Universal Life kept that share from decreasing further. However, Universal Life has had a significant and permanent effect on the life insurance industry, focusing attention on the separate investment and protection elements of all life contracts and changing the way companies must design, sell and manage their life insurance portfolio.