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Editor's note: Scott J. Witt, FSA, MAAA, ended a promising ten-year actuarial career at The Northwestern Mutual Life Insurance Company in 2004 to become a fee-only insurance and actuarial advisor for Katt & Company. He founded Witt Actuarial Services in 2007. He provides independent advice to his clients. He receives no compensation other than hourly fees paid by his clients. He also serves as an expert witness in insurance litigation. He holds an undergraduate degree in mathematics and computer science from Montana Tech, and a master's degree in statistics from Oregon State University. I invited him to submit this article, and he approved my editing. The article appeared originally in the November 2009 issue of *The Insurance Forum*. For a complimentary electronic reprint of the article in the form of a PDF, please contact the author at scottwitt@wittactuarialservices.com, or contact us. Permission is hereby granted to print the article from the PDF, provided the article is printed in its entirety.

A BEAR MARKET BAILOUT FOR THE LIFE INSURANCE INDUSTRY

by Scott J. Witt

The recent bear market appears to have done significant harm across the entire financial spectrum, but it has done especially extensive harm to variable universal life (VUL) insurance policies. Many inforce VUL policies are so badly damaged that even a market rebound may not get them back on track. See my article in the November 2008 issue of *The Insurance Forum* for a more detailed discussion of some of the points discussed below.

Minimally Funded Policies

The most common form of VUL that I encounter is a minimally funded policy with a level death benefit. At the time of sale, the agent used an illustration showing a level death benefit for life, with the premium at a level just high enough to support the policy under an assumed level gross annual rate of investment return between 8 and 12 percent. Even if the market performs on average as illustrated, a high percentage (20 to 50 percent depending on individual case particulars) of these policies would expire without value in the absence of strong corrective action.

VUL policies are chronically underfunded because sales illustrations fail to take account of market

volatility. Indeed, rules and regulations prohibit them from doing so. Also, agents have neither the financial incentive nor the training to alert their customers to these dangers. The failure percentages skyrocket if the average market returns are worse than illustrated and/or policyholders pay less into the policy than illustrated. Both of these situations are common now.

The Negative Interplay

Compared with other investment vehicles, VUL policies are more dramatically affected by poor market performance because of the negative interplay between investment returns and mortality charges. When investment returns produce cash values worse than illustrated, the resulting mortality charges are larger than illustrated, and that puts additional downward pressure on cash values.

It is common for an underfunded VUL policy to be in a condition where better-than-illustrated future investment returns cannot get the policy back on track. Only significant policyholder action can revive the policy to provide an acceptable degree of confidence that the coverage will last for life. Potential policyholder actions include replacement, decreasing

the death benefit, increasing the premium, selling the policy, or rolling the dice with the hope that the insured will not outlive the policy.

The Bailout

The bear market appears to have helped wipe away culpability for a vast number of poor VUL purchase decisions over the last 10 to 20 years. Instead of holding agents' feet to the fire about unsuitable recommendations—or more appropriately life insurance companies because they are responsible for training agents and have the resources to recognize the problem—policyholders are chalking up their policies' impending doom to the bear market.

These policies continue to be heavily sold in the VUL marketplace. I have yet to encounter a company that alerted its distribution channel to the dangers lurking behind those tantalizing illustrations.

Conclusion

Policyholder dissatisfaction will continue to increase unless we see a return of consistent double-digit returns to help dig policies out of their holes. Even then policyholders probably will have to pay additional premiums, especially where less premiums were paid during the bear market.

In our litigious society, it is not a stretch to envision policyholders going after agents and insurance companies for failing to educate potential customers about the negative effect of normal market volatility on VUL policies. Life insurance companies probably

will try to hide behind the rules and regulations that prohibit illustrations from showing anything other than level returns. However, that may not be enough to protect the companies from potential liability associated with their failure to recognize the phenomenon and/or their failure to educate their distribution channels.

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