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At Witt's End

Variable Life: Buyer Beware!
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Perhaps the most frequent problem that we encounter in our practice is the overutilization and/or mismanagement of variable life insurance policies. If life insurance consumers better understood the unique risks presented by a variable life insurance policy, we believe that the majority of variable life policies would be drastically altered or replaced - and likely would not have been issued in the first place.

Understandably, consumers want to get the most insurance they possibly can for the least amount they can possibly spend, and the allure of high investment returns enables agents and consumers alike to delude themselves into believing that a variable life policy is an appropriate long-term solution.

Recently, we were hired by a 48-year-old male in excellent health who was considering the purchase of a variable life policy with an illustrated level death benefit of $5 million. An annual premium of $42,750 was illustrated for 17 years (to age 65), after which no additional premiums would be required. Based on a level 10% gross return within the illustration, the account value would grow to $5 million at age 100.

We performed a Monte Carlo simulation to illustrate the major flaw with this proposal. We assumed that investment returns going forward would average 10% on a compound basis, but we simply introduced historical volatility into the equation. We randomly generated both investment returns and a date of death (based on mortality consistent with the risk classification). For each iteration, we determined what the death benefit would be at the time of death.

In 36% of the outcomes, the death benefit was greater than the desired amount of $5 million. In 29% of the outcomes, the death benefit was exactly equal to the desired amount of $5 million. **However, in 35% of the outcomes, the policy lapsed prior to the death of the insured.**

How is this possible? The short answer is that this phenomenon is due to the negative synergy between investment returns and mortality charges. This phenomenon is very poorly understood - even by sophisticated financial professionals - because the dynamics are unlike any other financial instrument.

The story gets even worse. Future returns very well could average less than 10%, and/or volatility could be worse than historical measures. Human nature also suggests that policyholders are apt to take premium holidays at precisely the time that they should be dumping additional money into the policy - and they may be unable or unwilling to pay the needed premium because they are taking a beating in the rest of their portfolio. Finally, many policies are past the point of no return long before the policyholder or agent has any inkling that trouble is on the horizon. The amount of premium generally required to get these derailed policies back on track is often shockingly high.

As if the above were not enough to give one pause about variable life insurance, there is another significant consideration. Variable life insurance policies are not subject to the Illustrations Regulation, a regulation adopted by most states in the 1990s to address the rampant illustration games that were being played throughout the industry. Because they are not covered by this regulation, variable life illustrations are far more likely to contain illustration enhancements that have little chance of coming to fruition. We always counsel our clients to not confuse the illustration with what is actually being purchased, and that advice is especially critical when dealing with variable policies.

Generally, individuals are drawn to permanent life insurance because they have some sort of permanent need. However, when individuals succumb to the temptations of variable life insurance, they often fail to realize that their long-term "solution" now resembles gambling more than it does insurance.

There may be some situations where variable life insurance is appropriate, but those situations are relatively rare. Consumers who own or contemplate the purchase of a variable life policy without expert, unbiased guidance do so at their own peril.