Variable universal life insurance: weighing the pros and cons

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The strong reactions that VUL generates among advisors — some swear by it while others swear at it — may help to explain the product's relatively low market penetration.

Variable universal life (VUL) remains a niche product. **LIMRA** reports that VUL represented just 8 percent of life sales in 2014, but sales are growing. According to Karen R. Terry, LIMRA's assistant managing director of insurance research, VULs had annualized premium sales growth of 24 percent in 2013 and 17 percent in 2014. The first quarter of 2015 also saw good results with 21 percent growth.

One possible reason for the relatively low market penetration is that VUL also generates strong reactions: some advisors swear by it while others swear at it. Advisors who recommend the policies highlight its benefits.

Lillian Meyers, a financial planner with Meyers Financial in Sonoma, California cites the product's value as a supplement to other retirement savings plans, in addition to the available insurance benefits.

"Let's say you've got the 401(k) but [not] a pension," she says. "[Buying a VUL policy] would be a good way to make sure that you are well covered in the retirement area. But, there are a lot of riders involved, as well, for more guarantees."

Other advisors like David Demming, a financial planner with Demming Financial Services Corp. in Aurora, Ohio, are highly critical. Demming previously worked with VUL but does not now. "As fee-based planners, we are very vocal in our condemnation of these overpriced products," he wrote in an email.

How it Works

Joe Miscolta, assistant vice president with Pacific Life Insurance Company's investment marketing unit-life division, provided the following details on the policy's structure. VUL is a form of universal life insurance (UL) in which the contract's earnings rate is based on the performance of the selected subaccounts.

Variable subaccounts invest in insurance dedicated funds, so their performance will change daily with the market. The variable subaccount assets are held in a life insurance company's separate account, which is kept separate from its general account, and protected from the life insurance carrier's general creditors.

VULs also offer access to a fixed account that works the same way as a UL policy. Its earnings rate is determined by the life insurance company and the declared rate will never be lower than the policy's minimum guaranteed rate. All assets in the fixed account are part of the insurer's general account. VUL products typically provide a wide range of investment options in their subaccounts.

Miscolta says that Pacific Life's current VULs offer 95 variable subaccounts, including several nontraditional and alternative investments. Two indexed accounts with crediting rates based in part on the S&P 500's price return, with a cap and minimum guaranteed rate, are also available.

Planning Applications

Sources agreed on the basic suitability profile for an ideal VUL buyer. The ability to tolerate investment market volatility is essential; otherwise, the client may cancel the policy in a downturn and incur investment losses.

G. Scott Cahill, managing director with Fulcrum Partners LLC, cites examples of clients who couldn't tolerate the equity markets' volatility in 2008 to 2009 and surrendered their contracts with resulting losses. An adequate time horizon is also required, says Brian Kazinec, a financial advisor with Prudential Advisors in Atlanta, Georgia.

"These contracts need time to 'stew and brew' so you don't want to utilize these contracts for somebody that's going to (buy) and then retire in two years," he says. "There's not enough time and flexibility and ability to put in money over a short period of time. So, I like to use these for people that have approximately at least eight years, 10 years before they're going to need to utilize the assets out of these contracts."

Consistent and adequate funding is important. Wes Shannon, a financial planner with SJK Financial Planning, LLC in Hurst, Texas, typically shows illustrations with amounts at or close to the maximum funding allowed under IRS modified endowment contract (MEC) guidelines.

The policy's death benefit is important, he says, but the emphasis is different with VUL.

"For VUL, most of the time, you're looking at the tax-advantaged and the favored protection of the cash value," he says. "You have to maximum fund [the policy] for it to work. If you're looking at trying to just buy a death benefit for a reasonable cost, VUL should not be your instrument."

Advisors differ on the ideal age for a buyer. Shannon looks for high-earning professionals in the "thirtyish" age range who have maxed out other retirement savings options and have a life insurance need.

In contrast, Cahill says older clients can benefit from VULs. He cites the example of a hypothetical buyer, age 63, who plans to work for another seven years and can afford to invest several hundred thousand dollars annually in the contract while he's still working.

Kazinec reports placing VULs successfully with clients ranging in age from their twenties to their fifties. Younger clients can increase premiums in later years based on catch-up provisions allowed under the MEC rules, he points out. "It's a carry forward, which is a great tool for younger folks to use with potential increases in income and bonuses and lump sums and inheritances in the future," Kakinec says.

VUL provides additional planning benefits. In many states, life insurance contracts' cash surrender value is exempt from creditors, which can benefit clients at risk of being sued. However, Cahill maintains that the most important factor is the policy's impact on the client's wealth.

"What I look at is, is my after-tax cash surrender value higher in the life insurance policy at the end of seven years or is it going to be higher if that (premium) goes directly into the mutual funds assuming, a blended tax rate on the funds of 30 percent?" asks Cahill. "If it's going to be higher in the cash surrender value on a projected basis, then of course [I buy the VUL policy] because I'm saving on taxes."

The Costs

The after-tax comparison requires considering VUL's costs and critics point to these fees as a significant drawback to VUL. The terminology can differ among insurers but policy fees and charges for VUL products are generally comprised of a premium load, administrative charge, cost of insurance, charges for optional riders and benefits, and in some cases, an asset based mortality and expense charge, Miscolta says. Also, the underlying insurance dedicated funds incur fund operating expenses, but these expenses are reflected in the daily unit value of each variable subaccount.

Charges such as cost of insurance, coverage charges, and certain optional riders are based on a person's age, gender, health status and/or occupational hazards, so it is very difficult to cite an average or approximate range, he explains. The best way to determine how changes influence policy charges is for an individual to obtain a personalized hypothetical illustration that shows how the VUL policy operates.

Cutting through the Complexity
As the list of fees indicates, VULs have multiple moving parts. Consequently, advisors risk overwhelming clients with details and policy options. Kazinec shows clients the interaction between subaccounts' rates of return and premium funding levels by presenting multiple possible outcomes.

"I'm always showing them different rates of return and different funding schedules so they get an understanding of minimum-type funding, target-type funding and maximum IRS funding," he says. "If you did that, based on the same rates of return, here's how [the illustration] looks."

The exercise is not just a sales technique; it's also an approach for minimizing potential compliance problems and clients' later claims that they didn't understand something about the contract.

Advisors need to be certain the client understands the product, he says, "So you don't get surprises later. It's all about doing the job right upfront so you don't have complaints down the road."

Cahill similarly spends ample time going through the illustrations. Every VUL carrier provides a cost sheet that usually details the premium, the purpose of the premium loads, the various costs of insurance, mortality and expense charges, policy fees, and taxes.

After reviewing those items, he shows the client internal rate of return calculations for both cash surrender value and the life insurance value (at the client's death) to determine a policy's potential after-tax financial return on the premiums paid. With that information, he can then compare the results to investing in a mutual fund or another taxable account.

He cites an example using a seven-pay proposal. Assuming a reasonable expected return on the policy's cash value and a suitable mutual fund, he compares the projected returns at the end of the seven years. If the outcome on the VUL is better than the taxable fund's outcome, it's worth considering the VUL, he says.

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