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Handling the "No Lapse" Hot Potato

Life insurers are at risk of getting burned by indiscriminate sales of "no lapse" policies to buyers who would be better suited to other products.

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IN recent months much skeptical commentary has surfaced about no-lapse life insurance policies. Critics of these policies are expressing their concerns in an ever-wider circle of insurance publications, as well as in the broader financial and estate-planning community. Carriers that don't offer no-lapse policies, and their agents, are raising concerns about those products and the companies that do offer them. And some insurers that offer these products are admonishing agents and buyers about the mispricing of no-lapse products by their competitors.

In a recent article in this publication, we expressed some reservations about the way no-lapse products are being marketed (see "The Post-Split Dollar World," Summer 2004). We noted that some producers show prospects only no-lapse universal life products even in situations where the insured's situation suggests that a different policy design may be in order. Since that article was published, the chorus of criticism and concerns about no-lapse products has become ever louder. Moody's, Fitch, and *Insurance Forum* editor Joseph Belth are among those that have spoken out.

There are many circumstances where a no-lapse product is suitable and attractive for an insured. This product is an excellent fit, for example, when an insured wishes to fund a trust with a gift of a single premium and be assured that for cash flow, gift tax, and generation-skipping tax purposes, no additional premium will ever be required to support the death benefit. Consider also the savvy, repeat insurance buyer who knows what he or she is buying and likes the elegant simplicity of the no-lapse product. But in many other cases, no-lapse is not the right choice, and selling it exposes the carrier to charges of misselling and other damaging allegations.

Echoes of the Vanishing Premium Debacle

Leaving aside the issues associated with reserving for the guarantees and pricing the products, we see a disturbing parallel between the sale of vanishing premium products in years past and the current-day presentation of no-lapse universal life (UL) products. In the strictest sense, vanishing premium was an illustration concept, while no-lapse is a product concept. Yet each represents the "easy sale." Vanishing premium illustrations made the sale easier because they showed a limited outlay for the coverage. While the actual annual premium did not decrease, the total number of payments was shown to be reduced, thereby facilitating the sale.

Today, the apparent low cost of no-lapse UL relative to a traditional whole life product enables the agent to more easily overcome the buyer's objection to the cost of a death benefit that is guaranteed for the buyer's "whole" life. And, at least at the superficial level, no-lapse UL calls for a much simpler explanation and fewer "what ifs," than its siblings: current-assumption UL or variable universal life (VUL). Generally speaking, with these current-assumption products, the sufficiency of the planned premium to support the death benefit for the insured's entire life depends on such factors as the crediting rate (on UL) or the market returns (on VUL), and, in either case, the carrier's cost-of-insurance. The impact of these factors on the premiums that the prospect plans to make is much more difficult to explain than the concept of just paying the no-lapse premium.

With the benefit of 20-20 hindsight, one could argue that the vanishing premium debacle came about not because products underperformed, but because they were "under-described." Neither the policies, nor the illustrations, nor the agents' jargon-laden explanations made it clear to the buyer that, for many reasons, it was pure conjecture as to when (or if) premiums would vanish. When the premium failed to vanish as promised, policyholders cried foul, saying, "Nobody told me this could happen." A flood of lawsuits ensued, and many insurers suffered reputational damage. No-lapse products threaten a repeat of this unfortunate experience.

The Suitability Issue

In fact, the marketing of no-lapse UL today involves a far more diverse set of risks to carriers and agents than did vanishing premium. The essential complaint about vanishing premium was that the buyer had to end up paying more premiums than originally forecast. But, typically there was no allegation that the product itself was unsuitable for the buyer because another type of product would have been more appropriate.

Not so with the no-lapse product. In many cases, the buyer of a no-lapse product could claim not only that he was sold the wrong type of policy for his needs, but that he was never clearly told how the policy really worked. Based on what we

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see happening in the marketplace, many buyers could be in this situation.

The unsuitability claim could arise in any one of several situations. For example, the policy could be unsuitable based on the insured’s facts, circumstances, and planning strategies. In the advanced markets, many agents are proposing designs such as split dollar and third-party premium financing with irrevocable life insurance trusts. These designs, which often depend on policy values for successful exits in a timely fashion, have a much greater chance for success if they are coupled with flexible-premium, current-assumption products that build robust cash values.

Further, the flexible-premium nature of these products allows the insured to minimize the premium and associated interest expense in the early years while the trust is being funded. Once that occurs, the trust can take over the premiums and eventually use the cash values to repay the premiums advanced by the insured or the third-party lender. Yet, in case after case, agents aren’t even showing current-assumption products. All they show is no-lapse UL, even though these products require a certain premium to support the death benefit, generate far less cash value than current-assumption products, have no potential for a lower premium or higher death benefit if interest rates rise, and could lose their guarantees once the insured/trust withdraws or borrows cash value.

The Agent’s Rationale

So, aside from the fact that the no-lapse UL might be cheaper than the current assumption product in today’s interest-rate environment, what is the agent’s rationale for failing to show the client current-assumption products? Agents offer these reasons:

- Clients prefer these products because they want assurance that the planned premium will support the death benefit.
- The major risk to policy performance in the years ahead isn’t interest-rate volatility but cost-of-insurance increases; thus, the no-lapse product is always prudent, even if the insured thinks interest-crediting rates are going up.
- No insured should ever buy a product that will depend on monitoring by an agent (i.e., current-assumption UL or VUL) because there is too much turnover in the business and, anyway, agents don’t have time to service old cases.
- Insureds don’t want to take risks with their insurance.
- With so much consolidation going on in the industry, it’s smart to buy a policy that an acquiring insurer cannot re-price.

The buyer of no-lapse product is likely to take a far different view. Once this buyer eventually realizes (or is told by a competing agent) that the product was not appropriate, he is likely to allege through his attorney that the agent showed only no-lapse UL simply because it was an easy sale. This is because, depending on the design of the product, it put the agent, rather than the buyer, in control of pricing, funding, and compensation decisions and essentially relieved the agent of all performance risks, except carrier solvency, and all responsibility for monitoring the policy.

The buyer’s attorney will contend that, knowing the client’s estate plan and the strategy selected for paying the premiums (e.g., split dollar), the agent should have shown the client additional products, pointing out the advantages and disadvantages of each in the context of the client’s estate plan and premium-paying strategy. Only in that way could the client make an informed decision. The attorney will ask, “Shouldn’t the client have been able to choose between a product with characteristics that fit well with his plan but might require additional premiums and a product that will not require additional premium but doesn’t have the characteristics needed to be most effective in his plan? Clearly, there are tradeoffs involved, but shouldn’t the client be allowed to make that call?”

Another case where a no-lapse product can be unsuitable from the outset is where, upon a Section 1035 exchange, the cash values of the existing product can support a lifetime no-lapse death benefit of perhaps $7 million, while the current-assumption product can support a death benefit of $8 million at assumptions the insured is quite comfortable with. And if the current-assumption product is blended with a term rider, it will support even more death benefit. But the agent shows the buyer neither alternative.

Buyer’s Remorse

Even where no-lapse UL initially appears to be suitable, it could become unsuitable if the insured’s situation changes. For example, assume that an

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insured tells the agent he is certain that (1) he needs that $500,000 of coverage forever, (2) will be able to afford the premium, and (3) will not need access to the cash value. A few years later, however, the premium becomes a stretch and he wants to decrease it. The agent shows him that if he reduces the premium, not only will the no-lapse guarantee fall away, but the policy will not perform well at all under the nonguaranteed assumptions.

While the agent certainly is not responsible for the insured's change of circumstances, the insured might well be upset that he was not shown alternatives so he could make an informed choice. In fact, he wonders why he was never shown an illustration for the no-lapse product that depicted the impact of a mid-course reduction of the premium. Given the vast array of uses of cash-value life insurance in financial and estate planning, and the likelihood of a change in the buyer's circumstances, there are many reasons why he or she can end up with buyer's remorse. But how can the agent protect himself against a revisionist buyer if he never showed the two types of products and explained the differences between them in the first place?

Even in the favorable examples we cited at the outset, the buyer should be shown that by choosing the no-lapse policy over the current-assumption product, he may be giving away upside in the form of an eventually higher death benefit or cash value. It's the buyer's choice, but the agent should make sure it's an informed choice.

The suitability issue aside, we are equally concerned that insureds (and many agents) simply do not understand what the products require of them and what will happen if those requirements are not met. Does the buyer really understand when a premium has to be paid in order to preserve the guarantee, the implications of making a late premium payment, taking a policy loan, or trying to use a "catch up" provision?

Preventing Tomorrow's Lawsuits

The drumbeat about no-lapse products is likely to become only louder. If a carrier is to help agents make sales that will stay on the books instead of becoming tomorrow's legal hassles, the carrier should require some protocol to ensure that the sales record reflects that the product was suitable for, and understood by, the buyer.

One approach would be to use some form of questionnaire, much like the one a registered representative must use when establishing a new account for an investment client. The form might ask such questions as:

- What is the purpose of the insurance?
- Do you anticipate that you will need/want this amount of coverage for the rest of your life? If not, why?
- Do you anticipate having any difficulty making the stated premium payments on time? If so, why?
- Do you need flexibility with your premium payments for any other reason? If so, how much?
- Do you anticipate taking cash from the policy through loans or withdrawals? If so, for what purpose?

Another approach would be to include some "plain English" in the policy illustration or in a separate document, signed by the insured, which explains that the no-lapse policy is generally appropriate for buyers who seek to guarantee permanent insurance coverage by paying a required premium, on time, for the life of the policy and will not access policy values. The explanation should go on to say, in plain English, that the guarantee will not be effective if premiums are not paid in timely fashion, if cash is withdrawn/borrowed from the policy, and if other clearly identified requirements are not met.

Finally, in the same way and for the same reasons that the illustrations for participating policies encourage buyers to see illustrations at lower dividend scales, the no-lapse illustrations should advise buyers that they should look at current-assumption products as well because, as a trade-off for the guarantee, those products may provide a greater death benefit under acceptable assumptions, allow more premium flexibility, and build greater cash value.

However much value a no-lapse product can add to a given buyer's financial and estate planning, the marketplace is just too competitive, and the environment too litigious, to leave agents and carriers exposed to the "nobody told me" charge. Some simple steps such as those suggested here might go a long way toward mitigating those risks.

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