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## How to Retire in the Magical Retirement Income Castle in the Clouds

“What looks too good to be true, usually is.”

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### ABOUT THE AUTHOR

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Lawrence J. Rybka is Chairman and Chief Executive Officer of Valmark Financial Group, which includes a broker dealer, an investment advisor and Executive Insurance Agency (the nation’s first producer group). Valmark serves 120 premier independently-owned and -run wealth management/transfer firms in 31 states and has helped place over \$45 billion of life insurance death benefits while managing insurance policies with a cumulative cash value of over \$8 billion. Valmark’s affiliated RIA, Valmark Advisers, has over \$6 billion in assets under management, including approximately \$3 billion in variable sub-account assets within its TOPS® funds.

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**Executive summary:** *This article examines the use of premium financed indexed universal life (IUL) policies to provide retirement income for clients. It explores the major assumptions in the IUL policies and in the bank loans used to finance them. Most importantly, it reveals undisclosed risks often taken by clients in these transactions.*

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I recently attended a top meeting in the US life insurance industry. During it, I experienced no less than three sessions where insurance agents shared presentations of major sales they claimed to have made during the year, each of which generated hundreds of thousands of dollars in commissions. All three presentations were variations on the recommendation that clients borrow significant sums to finance the premiums on IUL policies. The proposals showed that the loans would be paid back using projected policy cash values and have plenty remaining in the policy to provide a lifetime income of hundreds of thousands of dollars a year to the policyholder and a multi-million-dollar death benefit at the end. Each presentation proposed the clients borrow money from major commercial banks who were willing to lend \$2 to \$3.5 million to each client over five to seven years to purchase these policies. These proposals are not outliers but part of massive sales efforts by some insurance companies and banks to push products that may be good for them but carry significant risk for the client.

### **The Market For Premium Financed IUL Is Huge**

This concept of premium financed IUL gained broad attention in a 2010 *Wall Street Journal* article. It was being promoted by former KISS rock star Gene Simmons. In the article, the promoters claimed, “Cool Springs promises wealthy people that they can buy enormous insurance policies without spending any of their own money on the annual premiums, which can top \$300,000 for older people.” Cool Springs claims its “platforms have executed more than \$8 billion in transactions, all without any clients writing a premium check.” (It is unclear if Simmons is currently associated with this venture as he is no longer listed on the company’s website)<sup>i</sup>. One major money lender claims to have made over \$3.1 billion in life insurance premium finance loans over the last several years. A major insurance marketing organization reported that half of all its sales in 2017 resulted from this concept.

By looking at a few of the largest lenders making these claims, it seems that over 60% of all premiums written on IUL are financed. No question that there is a lot of IUL being sold with this concept that some might call a Leveraged Income Retirement Program or that others call a Bank-Funded Retirement Plan. The real questions are: Do these plans really work for most clients in the long term? What risks should policyholders/borrowers be particularly aware of in these transactions?

For baby boomers who have delayed saving for retirement, the prospect of not paying out-of-pocket premiums for a big free policy during their final days of working or being in the retirement red zone period is appealing. A transaction that includes a magic tax-free money machine with no premium payments powered by unicorns and rainbows is much easier than cutting spending leading up to retirement. The presentations look easy, simple and relatively risk free through four easy steps:

- 1) Take out a bank loan for \$500,000 per year for seven years.<sup>ii</sup>
- 2) Put the money in an IUL policy, which we’ll call the Rainbow 500.
- 3) The computer-generated sales illustration shows the cash value compounding at a steady illustrated rate, allowing the policyholder/borrower to take enough money out of the policy to pay back the bank loan.
- 4) Wait another couple of years and use the Rainbow 500 pot of gold to turn on hundreds of thousands of dollars of tax-free income from the policy and a tax-free death benefit at the end.

## **What Are The Risks?**

We will examine why, despite the stated rate in the illustration of 6% or 7%, the actual projected rates inside the newest version of IUL policies have bonuses and multipliers that result in much higher effective illustrated rates. Some of the most aggressive Illustrations show that for every dollar of premium put into a policy, the policyholder is projected to get 12-13% projected cash on cash returns. When these projected returns from the illustration are further leveraged by borrowing from external bank loans, where money is borrowed at a projected rate of 4%, it creates an illusion of a carefree retirement castle in the clouds, with almost no money out of pocket. This paper explores how the illusory financial arbitrage on these transactions is in fact regulatory arbitrage that will likely cause clients far more risk than they bargained for.

## **Conflicted Advice From Insurance Agents, Companies And Banks**

Unfortunately, many clients considering this type of transaction are being ill-advised by both the banks that are loaning them the money to buy the policies, and the insurance agent (who may also be employed by a division of the bank) pushing the purchase of these policies. In the last five or six years, advisors associated with our firm have been asked to provide second opinions on over 100 of these types of transactions, including proposals that non-profits borrow money to fund plans like these. To help clients better understand all the moving pieces, we have built a robust financial model that provides an independent assessment of the economics of these transactions. Once clients understand the risk from interaction of some of the variables, they almost never want to proceed with the transaction.

The Roman philosopher and statesman Seneca said, “Be wary of the man who urges an action in which he himself incurs no risk.” The Insurance companies, insurance agents and bankers have far more to gain from these transactions, through commissions and fees generated from the loans, than the clients who are persuaded to buy them. In fact, premium financing transactions often generate three to four times as much commission as non-leveraged life insurance purchases because the policies must be much larger to provide the desired benefit while supporting the repayment of the loan. A recent Society of Actuaries article surveying company profitability showed cash accumulation IUL products to be life companies’ highest margin products<sup>iii</sup>. Clients considering these transactions should proceed with extreme caution and always get a second opinion from someone who has no vested interest in the transaction. Loans of this magnitude backed by a personal guarantee are more likely to end in a retirement nightmare than a carefree castle in the clouds.

## **Nature Of The Transaction And Risks Of The Personal Guarantee**

These transactions go under a variety of names including Leveraged Life Insurance Retirement Plan or LLIRP, but the heart of the transaction is an IUL policy that projects to earn significantly more net of fees than the cost of the loan. While policy terms and loan terms may vary slightly from deal to deal, the basic mechanics of the transaction are much the same. These loans require a personal guarantee and are collateralized not only by the policy purchased but also by other assets (usually the client’s investment portfolio) of which the bank takes custody. The loan rate is usually based on a short-term

lending rate (LIBOR) which in today's low interest rate market is well below the rate at which the policies' illustrated rate is projected to accumulate. The rates and terms of the loan can change both on funds borrowed and funds that will need to be borrowed for future years' premiums. The numerous risks with the bank loan itself are usually in the final loan documents, but often the client is too far along in the transaction to fully consider them. Some of them include the risk that rates may go up and the client must requalify for the loan for future premiums and may be unable to qualify when financial fortunes have changed years later. If the marketable securities held as collateral go down, especially in years where the policy will not earn a credit, it creates an unexpected margin call.

### **What Is Index Universal Life (And What Isn't It)?**

The vast majority of premium finance transactions involve the purchase of an IUL policy (it is estimated that 5% or less of the transactions use whole life policies). The usual design is that money to pay back the loan and provide retirement income comes out of the policies through policy loans, creating even more leverage in the transaction. It is an axiom of finance that "leverage cuts both ways." While the illustrated results of borrowing third party money at 4% and having it projected to compound in a policy that may be illustrated as high as 13.5% look great on paper, clients should be informed of the major assumptions and how these multiple layers of leverage inside IUL policies can work in reverse. Our financial models illustrate the full consequences of this possible reverse leverage.

An IUL policy is a general account life insurance product. The cash values are not directly invested in equities, but bonds, as part of the life insurance company's general account. The life insurance illustrated proposals claim to earn equity-like returns even though it is primarily invested in bonds. The use of the index crediting method was first used in Equity Index Annuities in the late 1960s, but this crediting methodology was first applied in a life insurance product by Indianapolis Life in 1997, and additional companies have pushed the limits of these products since then. Unlike earlier versions of UL or Whole life, there is no stated rate that the cash values will actually earn.

### **Companies Can Change Key Elements Of How These Products Credit Cash Value**

So, if there is no stated rate, how exactly does an IUL credit method work? With an IUL policy, the company credits a portion of the increase in the referenced index subject to a cap on the upside to a policy's cash value, less other charges. IUL policies also have a floor or minimum credited rate when the referenced market is negative. Today that floor on most IUL products is usually 0% but may be 1% on a few policies. The cap is the maximum rate that would be credited to a policy in a given year, if the index is positive. These caps also have their own current and guaranteed levels. For most products the current caps today are between 9% and 12%. Perhaps the single most important thing clients must understand is that companies can and have lowered the caps on IUL Products. All contracts have guaranteed minimum caps that are much lower than projected in illustrations: usually between 1% and 3%. Let's look at various scenarios on what rate would be credited to the policy's cash value in an example where the policy in question had a current cap of 12%, a guaranteed rate of 1%, and the contractual ability to lower the cap to 3%. We look at rates credited in five scenarios, negative 5%

return, zero, plus 5%, plus 10% and plus 15%. The table below shows the earnings that would be credited to the policy after application of the cap and floor rates.

Increase / Decrease Index	Amount Credited to Cash Value		
	Current Cap 12%	Guaranteed Cap 3%	Reduced Cap 6%
-5.00%	+1.00%	+1.00%	+1.00%
0.00%	+1.00%	+1.00%	+1.00%
+5.00%	+5.00%	+3.00%	+5.00%
+10.00%	+10.00%	+3.00%	+6.00%
+15.00%	+12.00%	+3.00%	+6.00%

While the rate on an IUL policy is likely to fluctuate from year to year based on the index, most life insurance illustrations assume some common average of what these returns will be, based on the current cap. The computerized illustrations project this rate uniformly over the projected life of the policy and this inherent earnings volatility is a key risk that is ignored in illustrations. This is especially true when money is borrowed out of the policy to produce income for retirement.

### Additional Arbitrage From Policy Loans

IUL illustrations show distributions or retirement income coming from “tax free” loans against the policies’ cash value. There is a charge for this loan inside the policy, but the illustrated growth of the cash value using the average rate is greater than the loan value. A key assumption is that the policy stays in force for the life of the insured. If it were to lapse, it creates a huge taxable event. In the real world, markets don’t earn 7.1% each year. Years where the market is flat or down would have zero or 1% and would produce very different results, but the loan expenses continue inside the policy. A recent article in the *Journal of Society of Actuaries* highlights and helps quantify this risk; it points out that these IUL illustrations are fundamentally flawed. “The compliant illustrations available to policyholders and agents, which limit crediting rates to the maximum permitted by NAIC Actuarial Guideline XLIX (AG49) cannot model crediting rates realistically.” In regard to IUL policies with loans or withdrawals, “Making the right adjustments [to policy distribution amounts] is not easy, and it is not realistic to expect policyholders and agents to do it well, especially when clients reach their 80s or 90s.”

This *Journal* article pointed out that all IUL policies are exposed to sequence of return risk ... the order in which returns occur. “Even if the average credited over the life of the income stream is as good as illustrated, the policy can lapse and produce a large taxable income if the order of the returns is unfavorable.” Participating loans exacerbate this risk significantly. To convey the sequence of return risk, the actuaries conducted testing on a hypothetical product showing income streams from policy cash values from age 65 to age 100 using historical S&P returns from two 20-year time periods. One time period produced an average crediting rate 0.43% higher than the assumed illustration rate. Despite the slightly higher return, 38% of participating loan scenarios lapsed by age 90. The second time period produced an average crediting rate just 0.39% lower than the assumed illustration rate. A staggering 89% of policies would have lapsed by age 90 in those models and 78% would have lapsed by age 85<sup>iv</sup>. These risks compound other risks including that a company is likely to decrease its contractual

cap over time. It's important to remember that a policy lapse with outstanding loans will result in an income tax bill for the policy owner. Clearly, the risk is significant with the financed IUL product structures being promoted. With the huge premiums under such financed policies, the taxable income triggered by a policy lapse would be millions of dollars.

### **Attempts To Regulate IUL And Indexed Annuities**

Because the credited rates on IUL and indexed annuities reference certain external financial equity indexes, they are often compared to directly owning equities. Indexed products do not directly invest in equities, but theoretically invest a small portion of the general account in derivatives that track a portion of the increase in external financial indexes (often the S&P 500). There has been an ongoing battle to regulate indexed products as securities since their inception. Some insurance companies who did not wish to have their products or agents subject to securities laws, have fought to resist this undesired securities regulation. The SEC first sought to classify equity indexed products as security products in 1967. The court considering the matter ruled in favor of the insurance company and it was the prominence of the base guarantees in these products that kept them classified as a general account life insurance product rather than a separate account product.<sup>v</sup> For a time, it appeared that these products would face a regulatory overhaul when the SEC voted to classify indexed annuities and IUL products as securities under SEC-proposed Rule 151A starting in 2011. However, in a surprising turnaround, the insurance industry was able to avoid this classification by last-minute lobbying of the conference committee of the Dodd-Frank Bill called the Harkin Amendment. This amendment reversed the SEC rule and kept regulation of these products exclusively within the jurisdiction of state insurance regulators<sup>vi</sup>.

### **NAIC Actuarial Guideline 49**

Because these IUL products are not regulated as securities, insurance companies and agents have taken liberties with their illustrations and have projected crediting rates and sales materials in a way that would not be permissible had the SEC Rule 151-A gone into effect. The primary abuse today involves the inflation of the expected rates that the policies will earn. For a time, there was a race between life companies to have the highest illustrated rate and the most attractive computer-generated proposal to garner sales. This led to ever more bizarre crediting methods and assumptions on what the index would return, driving up illustrated rates. Often, the assumed rate used in the illustration was based on increasingly complex indexes with short historical look-back periods that were not a fair representation of the actual returns clients might incur. This was done so that the life insurance proposal would have greater illustrated values and a higher illustrated income.

It should also be noted since IUL policies do not actually invest in equities directly, the indexes referenced in index policies do not include the returns that come from the dividends from the actual stocks in the underlying indexes, including the S&P 500. The absence of dividends in an index over long periods of time makes a significant difference in returns. "Looking at average stock performance over a longer time frame provides a more granular perspective. From 1930–2017, dividend income's contribution to the total return of the S&P 500 Index averaged 42%."<sup>vii</sup> This absence of dividends and

the negative impact on returns usually is buried in the fine print of the contract that the policyholder will get after he or she buys the contract.

### **State Based Insurance Regulation Left Giant Loopholes That Allow Very Aggressive Assumptions**

In an attempt to rein in some of this abuse, the National Association of Insurance Commissioners (NAIC) issued Actuarial Guideline XLIX (AG 49) on December 11, 2016. Its stated goal was to bring uniformity to the illustrations of policies tied to an external index or indices by providing a reasonable cap on the illustrated credited rate. Uniformity across illustrations allows clients to more easily compare the policies offered by different companies.<sup>viii</sup> *It should be noted that this “compromise” allowed insurance companies to assume a 50% annual profit on their options by projecting an illustrated rate!*<sup>ix</sup> The unsustainability of illustrated rates on IUL can be proven another way. Index annuities, which are also issued by the same insurance companies that sell IUL, have a similar crediting method but much lower cap rates. A major study on all indexed annuities was published by Cannex in 2018<sup>x</sup> and showed that clients should expect no more than a 3% to 3.5% return on indexed annuities. Much of this was because the highest cap on any indexed annuity was 6% ... not the 12 % that was projected on IUL. In fact, most caps were at 5%. This means, in a good year, the balance would increase to 5% or 6%, but in a down year it would yield 0%. The same insurance companies that sell IUL have cap rates that are more than double what they have on their index annuities! This is largely because they cannot change the cap rate on index annuities during the surrender period and must return principal after that period; whereas with IUL, companies have the contractual ability to reduce the caps dramatically.

### **IUL Illustrations More Abusive Than Ever**

Despite state insurance regulators allowing companies to assume ongoing profits on derivatives of 50% annually in their IUL illustrations<sup>xi</sup>, the NAIC left an even bigger loophole in the AG-49 regulation in 2016. While the overall stated rates in IUL illustrations decreased from 10% to 11% before AG-49 to between 6% and 7% under the new rules, some of the most aggressive illustrations show more money coming out of the policies after the AG-49 changes were implemented. That is because AG-49 left the door wide open for insurance companies to use features called bonuses and multipliers to greatly increase the projected cash values in the policy projections. These features are why IUL sales illustrations which show 6% or 7% illustrated rates can show projected returns, cash on cash, that are double the level of the illustrated rate. But the words “projected and illustrated” are the operative words. Some of the most cutting-edge exploration of what is going on behind the curtain of IUL products has been done by Bobby Samuelson, the editor of the *Life Product Review*.<sup>xii</sup> Bobby is a former Vice President of Insurance at Met Life. In his previous role at Met, he designed life and annuity products for the companies; now he writes detailed reviews on these policies and the new lengths to which they have gone to make illustrations look better. Bobby was also part of the AG-49 working group and accurately predicted that companies would exploit just such a loophole.



## Regulatory Arbitrage, Why IUL Is The Choice For Bank Loaned Policies

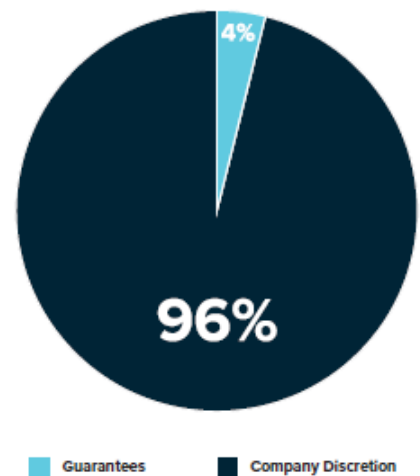
Not only do IULs avoid the SEC and FINRA requirements of detailed prospectus disclosure, approval of sales materials by a broker-dealer, and suitability requirements of being a security, but they also allow banks to make much larger loans than they would on any securities product. Had the SEC been successful in regulating IUL with Rule 151A, this market would not exist. Both requirements on broker-dealers and Rule 15c3-3 under the Securities Exchange Act of 1934 place specific requirements on this type of lending. There are also FINRA requirements of approval of sales materials that would likely prevent these proposals from being used. Banking Regulation U is a Federal Reserve Board regulation that governs loans by entities involving securities as collateral and the purchase of securities on margin. Regulation U limits the amount of leverage that can be extended for loans secured by securities for the purpose of buying more securities. Securities involved typically include stocks, mutual funds and other market-traded securities. Since IUL is not considered a security, the bank can count 100% of the cash value as collateral. Note the investments that also need to be pledged as part of the personal guarantee do not avoid this requirement and can only be given a 50% credit. While the loan grows as additional premiums are borrowed, there is significant risk that additional assets must be pledged, especially if a flat to down market for a couple years negatively impacts both the policy cash value and the collateral pledged.

		Guaranteed Charges				Current Charges				Current Charges			
		Guaranteed Interest: All Accounts 0%				Guaranteed Interest: Weighted Allocation 0%				Assumed Interest: Weighted Allocation 710%			
		Account Allocation: 100% Indexed Account, 0% Fixed Account											
End of Year	Age	Net Annual Outlay (t)	Net Policy Value	Surrender Value**	Death Benefit	Net Annual Outlay (t)	Net Policy Value	Surrender Value**	Death Benefit	Net Annual Outlay (t)	Net Policy Value	Surrender Value**	Death Benefit
1	56	36,000	23,563	2,812	536,153	36,000	26,458	5,707	536,153	36,000	29,636	8,885	536,153
2	57	36,000	45,504	25,358	536,153	36,000	51,208	31,062	536,153	36,000	62,118	41,973	536,153
3	58	36,000	65,904	46,364	536,153	36,000	74,380	54,840	540,600	36,000	97,473	77,934	563,693
4	59	36,000	84,793	65,860	551,013	36,000	96,069	77,136	562,289	36,000	135,989	117,055	602,209
5	60	36,000	102,213	83,885	568,433	36,000	116,372	98,045	582,592	36,000	177,967	159,640	644,187
6	61	36,000	118,180	103,713	584,400	36,000	135,363	120,896	601,583	36,000	223,720	209,253	689,940
7	62	36,000	132,682	122,197	598,902	36,000	153,114	142,628	619,334	36,000	273,589	263,104	739,809
8	63	36,000	145,701	138,954	611,921	36,000	169,679	162,932	635,899	36,000	327,934	321,187	794,154
9	64	36,000	157,252	153,997	623,472	36,000	185,114	181,859	651,334	36,000	387,153	383,898	853,373
10	65	36,000	167,390	167,390	633,610	36,000	199,467	199,467	665,687	36,000	451,676	451,676	917,896
11	66	0	149,415	149,415	350,795	0	182,398	182,398	350,795	0	488,446	488,446	586,135
12	67	0	136,458	136,458	350,795	0	170,783	170,783	350,795	0	533,358	533,358	634,696
13	68	0	123,678	123,678	350,795	0	159,752	159,752	350,795	0	582,159	582,159	686,947
14	69	0	110,992	110,992	350,795	0	149,256	149,256	350,795	0	635,421	635,421	743,443
15	70	(75,498)	22,845	22,845	275,297	(75,498)	63,750	63,750	275,297	(75,498)	617,010	617,010	727,811
16	71	(13,604)	Lapsed	Lapsed	Lapsed	(50,332)	Lapsed	Lapsed	Lapsed	(75,498)	600,525	600,525	713,591

## Illustrations Don't Accurately Depict Values Policy Will Produce

The above snapshot of an IUL sales illustration showing retirement income demonstrates just how big the gap can be between what is illustrated and what could happen should an insurance company exercise its rights to increase charges while decreasing caps rates on the indexes on an IUL policy. The

### Total Projected Benefits



## Conclusion

Life insurance illustrations have always been subject to abuse. Particularly in the last 30 years, amidst an environment of falling interest rates, the projections of the fixed rate of credited interest on dividend rates for whole life or current rates on traditional UL policies have resulted in policyholders having to pay more for their life insurance than expected. The failure of AG 49 allows abuse utilizing IUL illustrations and takes this to a whole new and seemingly purposeful level. The client's risks are multiplied when premiums are financed with external bank loans. The downside for these clients is not only limited to having to pay more of their life insurance, but also the potential to severely undermine the clients' entire balance sheet as loans are called and policies are subject to lapse with huge tax bills. At an absolute minimum, clients and advisors must understand that IUL is the most complex and opaque form of life insurance ever created and it gives insurance companies far more discretion to impact policy values than any life product in history. Rather than creating free insurance and tax free retirement in a castle in the clouds, clients should understand it as a risky bet with dice that seem to be loaded to favor the insurance companies and banks, leaving the policyholders with a transaction that is much more likely to destroy retirement than secure it.

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- <sup>i</sup> “Rock by Night, Life Insurance by Day”, Leslie Scism and Laura Saunders, *The Wall Street Journal*, April 3, 2010. Retrieved from <https://www.wsj.com/articles/SB10001424052702304871704575159691255776482>; <https://coolspringsfinancial.com/about>.
- <sup>ii</sup> The loan does require a personal guarantee and is collateralized not only by the policy but also by investment assets.
- <sup>iii</sup> “Annual Survey Provided Insights into the Universal Life and Indexed UL Market”, Susan J. Saip, *Product Matters!*, Issue 111, October 2018, Society of Actuaries.
- <sup>iv</sup> “Why Indexed Universal Life (IUL) Income Streams Need to Be Managed: Part 1”, Ben H. Wolzenski and John S. McSwaney, *Product Matters!*, Issue 111, October 2018, Society of Actuaries.
- <sup>v</sup> SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967) (“United Benefit”).
- <sup>vi</sup> “Consumer advocates critical of annuity proposal”, Tara Siegel Bernard, *New York Times*, (RD June 22, 2010); “Dem-Sponsored Loophole In Financial Reform Bill Could Hurt Seniors”, *Huffington Post*, Updated: 05/25/11; “Congress sells out seniors: No SEC regulation of indexed annuities”, Jane Bryant Quinn, [Janebryantquinn.com](http://Janebryantquinn.com), July 7, 2010.
- <sup>vii</sup> “The Power of Dividends; Past, Present and Future”, 2019 Insight, Hancock Funds. Retrieved from <https://www.hartfordfunds.com/dam/en/docs/pub/whitepapers/WP106.pdf>.
- <sup>viii</sup> “Life Insurance Illustrations”, NAIC Center for Insurance Policy and Research, last updated 10/04/18. Retrieved from [https://www.naic.org/cipr\\_topics/topic\\_life\\_insurance\\_illustrations.htm](https://www.naic.org/cipr_topics/topic_life_insurance_illustrations.htm).
- <sup>ix</sup> NAIC AG-49 “The Application Of The Life Illustrations Model Regulation To Policies With Index-Based Interest 5(A),” adopted by the Life Insurance and Annuities (A) Committee – Dec. 11, 2016.
- <sup>x</sup> “Accumulation Value of Fixed Annuities (MYGA & FIA): Understanding Yields by Product Design”, Branislav Nikolić, Tamiko Toland, Damian Baboolal, CANNEX Research, April 2018.
- <sup>xi</sup> Ibid.
- <sup>xii</sup> “The Life Product Review”, Bobby Samuelson. Retrieved from <https://lifeproductreview.com>.
- <sup>xiii</sup> Historical rates from LifeSpecs system on [www.looktowink.com](http://www.looktowink.com).