A GUIDE TO LIFE INSURANCE PRODUCTS AND THEIR RISK CHARACTERISTICS

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I. General.

A. Investment Risk in Permanent Policies.

As discussed below, there is some level of investment risk in all permanent policies (perhaps other than traditional, non-participating whole life policies or the newer no-lapse guarantee universal life policies). See the graphs attached as Exhibits, depicting the degree of investment risk in various types of permanent policies and the relationship between that risk and policy owner control over it.

As also discussed below, getting clients and their advisers to understand this concept and monitor their policy's performance is crucial – the greater the potential investment risk inherent in a policy, the greater the need for on-going monitoring; especially where investment performance (whether in the form of dividends, crediting rates, or equity performance) is intended to offset increasing mortality costs in term riders, to "quick pay" premiums, etc.

As further discussed below, most types of policies purchased today do not have required premiums, fully guaranteed investment returns nor guaranteed insurance costs, meaning that they are not "buy and hold" policies – they are "buy and manage" policies. They need to be continually tested, to be sure the actual (not projected) investment returns and expenses are being "matched" with premium payments, to reduce the risk that the policy will lapse. The problem is compounded by the fact that policy illustrations assume constant rates of return throughout the life of the policy; the following slides highlight that issue.

B. Credit Risk in All Policies.

There is also some level of credit risk associated with all life insurance policies, term as well as permanent – will the carrier be there to pay the death benefit and will the cash value in a permanent policy be available to the owner when needed? There have been carrier failures over the years, but the recent credit crisis has underscored this risk, perhaps for the first time for many insureds and their advisors.

Clients can respond to this risk by evaluating a carrier's rating from the rating agencies and monitoring it on an on-going basis. There is (so far at least) no federal supervisor nor federal insurance backing up any carrier's obligations – to the extent there is regulation and any indemnity funding, it is done at a state level (except for the limited regulation of variable policy sales material by the S.E.C., as described below).

While any particular state regulation of insurance carriers or products may, or may not, be rigorous, it is clear that no state insurance fund could rescue a large, insolvent carrier. So far, at least, every insolvent carrier has been taken over by a solvent one, with state regulator assistance (or direction). Since 1983, there have been about 100 carrier insolvencies, most during the early 1990s. From 1991 to 2010, on average policyholders of insolvent companies have recovered about 96% of their values. In any event, state insurance funds only provide coverage for limited amounts of death benefit or cash value. While the state statutes differ, they typically cover up to $300,000 in death benefits and $100,000 in cash value.

In addition, as described below, variable policies, as separate account policies, provide protection against the claims of the carrier's creditors (for all accounts but the money market account and – importantly – the account out of which the death benefit is paid); whole life and universal life do not.

C. Cost of Insurance Risk in Universal Policies.

In these types of policies, the insurer has the ability to increase costs of insurance, based on its mortality experience, on a policy class basis, with no notice. This is another "moving part" in these types of policies.

D. Policy Illustrations.

Life insurance policies have traditionally been sold based on illustrations of projected future values, prepared by the issuing insurer, showing fixed premiums and constant, guaranteed returns on policy cash values. Those illustrations made sense when policies had fixed premiums due for life, as well as guaranteed death benefits and cash values. As discussed below, that is no longer the case for most current versions of policies, but illustrations continue to be used to sell those policies, based on constant assumptions about costs of insurance and rates of return throughout the existence of the policy for perhaps 20, 30 or 40 years. As also discussed below, that should give proposed insureds and their advisors pause about relying on illustrations to compare policies or decide which one to purchase.

II. Policy Pricing and Illustrations of Permanent Policies.

The premium pricing of all permanent (i.e., non-term) life insurance products consists of three components: (1) a mortality charge, generally based on mortality tables which assume all insureds die by age 100 (2001 CSO mortality tables for policies issued in 2009 or later; 1980 CSO mortality tables are used for earlier policies; 1958 CSO mortality tables are used on older policies); (2) expense loading, including sales commissions, underwriting and administrative expenses; and (3) investment experience or return (on the savings element).

Since these are the major variables in pricing of a life insurance product, all policy illustrations (for any permanent insurance product) should show alternative scenarios of both higher mortality costs for policies without guaranteed costs of insurance (perhaps up to the maximum guaranteed rates), as well as lower investment experience (at 100 or 200 basis points below the results illustrated, or perhaps at the lowest guaranteed rate, if any). Lower investment results can, alternatively, be used as a proxy for higher mortality costs or other expenses.

In addition to these components, policy persistency (how long policies stay in force) affects carrier profits and therefore the performance of in-force policies. Because of the initial acquisition costs associated with a policy, it takes several years for the carrier to recover its costs and begin to turn a profit on a policy series; early lapses prevent the carrier from recouping its losses sustained in the early years of the policy. On the other hand, policy lapses in later years, when those costs have been recovered, but before the death benefit is payable, actually are profitable for the insurer.

In fact, many policies are priced assumed some level of profitable lapses; this is called "lapse supported pricing," and lowers overall policy premiums (perhaps by as much as

10-15%). The rise in the life settlement market for older insureds' policies had begun to decrease lapses in old, often large policies, because the purchaser will not allow the policy to lapse (since it will recover its investment only at death). This development calls lapse supported pricing into question, which is why some carriers oppose life settlements. In addition, policy illustrations should disclose any possible "tricks" which would affect policy performance, such as assumed improving mortality experience, lapse support (meaning, as noted above, that policy pricing assumes that some policies in a given series will lapse prior to the insured's death, and will provide support for the other policies in the series – if that assumption is incorrect, those other policies probably won't perform as projected), terminal dividends, "bonus" interest, etc.

The illustration should be tested and periodically re-tested against current carrier experience – the illustration probably should never reflect better results than actual current experience.

Clients and advisers should understand the limitations of illustrations and recognize that the policy that illustrates as "the best" policy may not in fact hold up over its 30, 40 or 50 year expected duration. Clients should probably be reminded about how, at the time, the illustrations from now defunct Executive Life looked much better than those of other, more conservative, carriers. This may be a place where the "cheapest" product (i.e., the one with the lowest projected annual premium) may not necessarily be the "best" one. This is counter-intuitive, and is therefore very difficult for many clients and their advisers.

What clients should look for is a policy from a financially sound carrier, with reasonable illustrated results, taking into account investment return, expenses, and mortality charges,

which, based on reasonable assumptions, is projected to last well past actuarial life expectancy (perhaps to age 110 or 120, recognizing that life expectancy is the point at which one-half of the insureds are alive, and the other half not-so-much). Clients should consider hedging their bets, by choosing multiple carriers and multiple policy types (in large cases), both as a hedge against carrier insolvency and to diversify potential investment risks. Finally, clients should also look for a policy series that the carrier will continue to support in the future – one that is central to its sales strategy.

In any event, clients should actually consider paying more into the policy than is required to put it in force (and be encouraged to do so), to provide an extra cushion against lower future returns or higher future expenses (or both); again, this is a difficult (if not impossible) decision for most clients (especially where paying more premiums has transfer tax consequences).

Clients and their advisers need to remember that policy illustrations are only a display of possible policy results, based on a particular set of assumptions, for anything other than traditional non-participating whole life policies (and are especially important in variable policies). One famous quote about illustrations can be paraphrased as: They are financial illustrations of what might happen if certain disclosed and undisclosed assumptions prove to be true.

And again, those assumptions should be continually tested by obtaining additional illustrations at lower assumed interest rates or rates of return (which can be used as a proxy for higher mortality or other expenses), probably on an annual basis (especially for universal, equity indexed, and variable policies).

Clients need to be reminded that life insurance policy illustrations are unique in the investment world – they do not reflect past results (as the illustrated values for other financial instruments must), but purport to reflect future results, sometimes out 50 or more years, at constant returns for the entire extended period. This is another reason why they should be approached with a fair degree of skepticism (if not downright disbelief).

As will be seen, the development of the newer forms of permanent insurance, while they offer premium flexibility and the potential for higher investment returns, also place more (or all) of the investment risk on the policy owner, rather than the carrier; again, requiring on-going management of the policy, to be sure it lasts as long as the insured does, by re-evaluating premium payments to conform to actual policy performance.

Adding a term insurance rider to a permanent policy, while potentially lowering premiums, makes the policy less stable by increasing the risk of poor performance or increased expenses (or both), where policy values are intended to be available pay premiums in the future. The same is true for policy loans taken out to pay premiums – while they may eliminate a current premium payment, they reduce cash value and add an ongoing interest cost, which also de-stabilizes the policy.

As noted above, life insurance (perhaps other than term, non-participating whole life, or no-lapse guarantee universal life), should be viewed by clients and their advisors not as a "buy and hold" asset, but a "buy and manage" asset. Those clients and advisors should also understand that, while there are plenty of folks who will help a client "buy" insurance, there are few, if any, who will help them "manage" it, once it is bought.

The only way to effectively manage such a policy is to have its performance re-illustrated periodically, at current values, so that the premium funding level can be re-evaluated and, if necessary, adjusted upwards.

Finally, as noted below, in universal type policies, costs of insurance are illustrated at current (lower) rates, but are subject to adjustment by the carrier to the (higher) guaranteed rates, perhaps (as discussed below) having nothing to do with its actual mortality experience. Any such adjustment would, however, have to be on a uniform basis for all insureds in a rate class.

One suggested basic policy management technique for flexible premium products is as follows:1

A. For Universal Life policies, where the crediting rate is declared by the carrier:

1. Review the "typical" in-force illustration with the current funding premium, current expenses, and currently declared crediting rate. If the policy is 8 - 10 years or older, the crediting rate is likely to be the guaranteed rate (4% prior to ~ 2003, 2% or 3% thereafter), and there should be no expectation that the crediting rate will ever be higher.

2. If the policy does not illustrate to "last" to an acceptable age (life expectancy plus 5 years), then request a recalculation of sufficient funding premium to life expectancy plus 5 years at current rate / current expenses.

3. Most carriers cannot illustrate anything between the current expenses and guaranteed expenses. Unless or until it's apparent that the carrier is

1 Provided by Dick Weber, The Ethical Edge, Inc.

starting to exceed its originally projected expenses, generally don’t use the guaranteed expenses in an illustration request, unless the owner/trustee wants to review a "worst case."

B. For Variable Universal Life policies, where the crediting rate is determined by the investment returns in sub-accounts:

1. Follow the process described for universal life, but request an in-force illustration with the current funding, current expenses, and no more than 7% assumed gross crediting rate (6% to be safely conservative).

2. If the policy doesn't illustrate to "last" to life expectancy plus 5 years at a minimum, then request a recalculation of a sufficient funding premium with no more than 7% assumed gross crediting rate (6% to be safely conservative).

C. For Equity Indexed Universal Life policies, where the crediting rate is determined by an independent index:

1. Follow the process described for universal life, but request an in-force illustration with the current funding and current expenses, and no more than 5.5% assumed gross crediting rate (5% to be safely conservative).

2. If the policy doesn't illustrate to "last" to life expectancy plus 5 years at a minimum, request a recalculation at a sufficient funding premium with no more than 5.5% assumed gross crediting rate (5% to be safely conservative).

D. 1. Note the emphasis in each of these suggestions on determining a "**sufficient funding premium**" at lower crediting/return rates and higher mortality costs.

2. This is the critical issue in policy management for these types of policies – will the policy sustain itself to life expectancy and beyond at the premium originally suggested (not required) by the carrier?

III. Policy Types.

A. Traditional Whole Life Insurance Policies (WL Policies).

A whole (or ordinary) life policy has a fixed (non-increasing) /premium, which is due each year over the contract life. The premiums are averaged, creating a reserve for the insurer, since mortality costs are actually lower than the average in early years and higher in later years. That reserve is essentially the policy's cash surrender value. Usually the underlying reserve (and cash value) of the policy equals the policy face amount at age 100; at that point, the policy "endows" and is no longer life insurance.

There is a fixed death benefit (assuming only that premiums are paid as due). As discussed below, in participating policies, (which are issued by mutual companies) the death benefit may be increased over time through the use of dividends to purchase additional paid-up whole life insurance ("PUAs", paid-up additions, or paid-up "adds") or term insurance. The increased death benefit resulting from using dividends to purchase PUAs can also be reduced (to the face amount) by surrendering those PUAs.

Except for surrendering PUAs, the death benefit may be decreased only by borrowing cash values, since the loan (plus any accrued interest) will be deducted from the death proceeds. However, if the borrowed amounts are invested by the insured in another form, that may effectively prevent the "overall" death benefit from decreasing, depending on the net-after tax investment return on the "side fund."

The policy can be maintained for life, and premiums are literally payable for life; however, under some sort of so-called "vanishing premium" formerly used or "quick pay" scenario, they may be shown in an illustration as payable for some shorter period.

Note that, as discussed below, despite the phrase "vanishing premium" in such plans, the premium in these types of plans never actually "goes away" – it is just being paid out of policy values, created by dividends, rather than by cash contributions (assuming those policy values are in fact available as projected). The risk is that "vanished" premiums will "reappear", because of lower than projected dividend rates; for that reason, the "quick pay" description may be more accurate (and is the favored description of this technique).

The earnings on premiums paid in early years are being used to offset premiums due in later years, because the premiums were higher than those required to be paid over life expectancy. When policy projections for this technique assumed constant investment interest yields (when rates were high), when interest rates declined, premiums "reappeared" – sometimes for decades – leading to a number of class-action lawsuits against carriers or agents. Current illustrations are much

more careful to point out this risk (and to avoid the "vanishing premium" description).

The policy cash value is guaranteed to increase at stated rates (assuming again only that premiums are paid as due). The increases in cash surrender value (and, as discussed below, dividends, in participating policies) are determined by the carrier's investment returns, based on a so-called portfolio rate of interest earned in the fixed income market – mainly mortgages and long-term bonds. These portfolio rates change slowly over time, reflecting increases or decreases in long-term rates incrementally (as older bonds mature and are replaced by new-money instruments). In an era of rapidly increasing short-term rates, portfolio rate products illustrate less well than so-called "new money" rate products.

When universal life policies were first being developed, an era of historically high short-term rates, they used new money rates, which gave them an illustration advantage. In today's interest environment, however, portfolio rates will likely illustrate as well (or better) than new-money rates (and, as discussed below, most universal life policies use portfolio rates today).

In whole life policies, the insurer bears all of the future investment risks, since, assuming premiums are paid as due, the policy cash value increases and death benefit are guaranteed (except, as noted below, for those increases resulting from policy dividends). The mortality costs and administrative expenses of these policies are, however, not guaranteed; as noted below, they are not even disclosed.

The guarantee of increases in cash values and a guaranteed death benefit (both assuming premiums were paid as scheduled), because of the assumption of all policy investment risks by the carrier has a cost. In part, the "cost" of the guarantees – lower investment returns – is what lead to the development of universal and other "newer" type policies; as noted above, this was especially true in the late 1970s and early 1980s, because traditional whole life policies based their returns on the carrier's portfolio rate of return (which increased slowly in that era of rapidly rising short-term interest rates). As noted below, these newer types of policies responded to the demands of consumers for "better" returns on insurance by eliminating the traditional policy guarantees (and putting more – or, in some case, all – of the investment risk on the insured).

Note that a whole life policy is not term insurance plus a separate savings account – it is a unitary financial instrument. However, such a policy can be viewed as being two independent pieces (and that way of viewing the policy was what allowed the development of the first universal life policies).

The cash values are available to the policyholder at any time by surrendering the contract to the insurer, which is a taxable event, generating ordinary income (because there is no sale or exchange to support a capital transaction).2 The gain is measured by the difference between the amount received and the owner's "investment in the contract" – a basis-like concept. Investment in the contract is premiums or other consideration paid, less, in the case of participating policies,

2 Section 72(e)(5)(A) and (E); Reg. Sec. 1.72-11(d)(1); but note that while there is an argument for capital treatment, based on Section 1234A providing the missing sale or exchange there is also an argument for ordinary income treatment, based on the substitution of income theory.

amounts received as dividends which were excludible from income.[3] Dividends in participating policies received in cash or used to reduce premiums will reduce investment in the contract, as will dividends used to purchase term riders; dividends used to buy paid-up additions effectively won't (since they will have become a part of the policy cash values, by re-investment).

Note the rise in popularity of life settlements – sales of policies to investors for amounts in excess of cash values – as another way to realize the lifetime value of a policy (often for more than its cash surrender value, where the insured is older and has had a decline in health since taking out the policy).

The tax consequences of such sales weren't always clear – gain up to cash value was thought to be taxed as ordinary income, and any excess gain was thought to be capital; policy basis (which is the relevant measure of "cost" in a sale, rather than investment in the contract, which is only relevant in policy surrenders), was reduced (at least according to IRS private letter rulings, with which most commentators disagree) by the cost of insurance – an undefined term.[4] It required a basis reduction for the cost of insurance (however that is determined) in policy sales, but not surrenders, and holds that gain over that reduced basis, up to cash value, is ordinary (as a substitute for interest), and that gain in excess of cash value is capital. The basis reduction portion of that ruling was revoked retroactively by the 2017 Tax Act.

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3 Sections 72(c)(1) and 72(e)(6).

4 See Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, which now provides the rules for sales of policies, at least in the life settlement market.

The policy owner also has access to policy cash values by borrowing. Borrowing has no tax consequences (assuming the policy is not a modified endowment contract), even if more than investment in the contract (again, cumulative premiums, minus dividends in participating policies received in cash or used to reduce premiums or buy term insurance) is borrowed (unless the policy is thereafter transferred, subject to the loan, which is treated as a sale – with the loan proceeds treated as the amount realized) or is surrendered, with the loan treated as part of the surrender proceeds. In modified endowment contracts (MECs), policy loans are treated as distributions and carry out policy income first (and will be subject to a 10% penalty if the "taxpayer" is then under age 59-1/2).

Interest (at rates – fixed or variable – specified in the contract) is charged on policy loans, and interest at a lower rate will be credited to the policy, so the cost is only the spread. Policy loans may be repaid at any time. Any unpaid loan amount (plus accrued interest) is deducted from the proceeds, if the death claim is paid, or from the cash value, if the policy is surrendered. Importantly, these are non-recourse loans - there is no personal liability for repayment of a life insurance policy loan.

Cash values can also be borrowed to pay premiums or used to turn the policy into a paid-up policy in a reduced face amount or into extended term insurance. Note that withdrawals are not permitted (as they are in universal life policies), but in participating policies, the cash surrender value of paid-up additions can be surrendered, which, in non-MEC policies, will be income tax-free (up to investment in the contract, as defined above).

Dividends paid by mutual life insurance companies (which are owned by their policy holders, rather than by shareholders – as is true in stock insurance companies) on so-called participating policies are, in essence, a return of "excess" premiums, shared with policy holders, since there are no shareholders with which to share them. Dividends reduce basis and are tax-free, until basis has been recovered.

Dividends can: (1) be used to buy paid-up additional whole life insurance; (2) be used to reduce premiums; (3) be paid to the policy owner in cash; (4) be left with the carrier at interest; (5) be used to buy term insurance; or (6) some combination. As noted above, in a non-MEC policy, the surrender of PUAs can be used to access policy values on a tax-free basis, without borrowing.

Dividend illustrations show dividends expected to be paid, based on current assumptions, as if the carrier's recent mortality, expense and interest experience were the actual basis of future dividends.

Dividends are not guaranteed; they are the one part of a traditional whole life policy that is not guaranteed. They are based solely on the insurer's favorable investment returns or expense experience, or both, as and when declared by the insurer. Accordingly, any dividend illustration should show alternative projections at 100 or 200 basis points below that illustrated. This is especially critical if the dividends are going to be relied on to make the policy perform as assumed – for instance, to "quick pay" the policy, support the increasing costs of term blends; etc.

Dividend projections, if based on the carrier's portfolio rate (which changes slowly over time) may be more reliable than the interest projected to be credited on universal life policies (described below).

As noted, dividends are declared at the discretion of the carrier – how much of their "excess" profits they want to share with their policyholders is up to them (and isn't disclosed and is therefore non-reviewable). As carriers become more conservative, because of ratings pressures, dividends will likely continue to trend downward (which they had been doing because of the current interest rate environment anyway).

These policies are what are known as general account policies, which means the cash values are subject to the claims of the carrier's creditors.

B. Universal Life (Flexible Premium) Insurance Policies (UL Policies) Including No-Lapse Guarantee Policies (NLG Policies).

These are unitary policies, mostly issued by stock companies (some of which are subsidiaries of mutual companies), composed of two elements – a risk element (the death benefit) and an accumulation element (the cash value).

The risk element provides the policy owner with two choices: (a) Option A – provides for a level death benefit (the death benefit includes the cash value); as noted above, this option is the only death benefit arrangement provided under traditional whole life policies where the cash value is a part of and paid out with the death benefit, and (b) Option B – provides for a so-called indeterminate death benefit (the death benefit is the sum of the accumulation element plus the face amount). Here, since the death benefit will be higher than under Option A, the

mortality costs will be higher (which will mean that, unless higher premiums are paid, less will be in the accumulation account to earn interest). Electing this option after policy issuance will require evidence of insurability, unless the election is effective only prospectively.

The accumulation element is credited with interest, as it is earned by the insurer and added to the accounts of its policyholders. As noted above, in many policies, the interest credited was initially a so-called "new-money" rate, based on short-term obligations, where changes – up or down – were passed through to the policyholder more quickly than in whole life portfolio rate structures; most universal life policies use the more stable portfolio rate now.

The investment risk in these policies is effectively passed through to the policyholder – whatever interest is earned (after expenses) is credited to policy accounts, except to the extent of the guaranteed minimum crediting rate, initially usually 4 or 4.5% - currently, more like 2.5% or 3%. See policy mechanics, below.

Some universal life policies, which are issued by mutual companies, are participating; in these policies, some company earnings are returned to shareholders in the form of increased returns on the accumulation element (rather than as separately stated dividends as in participating whole life policies).

Note that, except for the guaranteed minimum interest, policy illustrations for universal life policies are merely projections of anticipated interest rates that can (or may) be earned in the future and cost of insurance and other expenses that are projected (but not guaranteed) to be charged in the future. It is critical that clients

and their advisers understand this concept and not rely on initially illustrated amounts, without having them both initially illustrated at lower returns as well as having them periodically re-illustrated, using actual performance. Given the general decline in rates since many of these policies were issued, the re-illustrated results may be startling – especially if higher rates were projected to "quick pay" the policy or to support premiums for term riders.

As noted above, these policies were designed to respond to consumer complaints about low yields in traditional whole life products. They became popular in the 1970s – an era of high short-term interest rates, because they were then based on new-money rates. As noted above, most universal life policies now use a portfolio rate to credit interest to the accumulation account, because of the long-term downtrend in short-term rates. The decline in their popularity in an era of declining current rates lead, at least in part, to the development of variable policies, described below, offering the possibility of higher returns, keyed to the long-term performance of equities (rather than interest earned in the fixed income market) – and we all know how that worked out.

The trade-off here at the time was a "better" (i.e., current, new-money, market rates of interest credited to policy values) return, but few guarantees. In these policies, insurance carriers have shifted most of the investment risk to the policyholder (except to the extent of any minimum guaranteed rate), in response to consumers' requests for better investment returns in insurance products. As noted above, in an era of lower interest rates, these policies may not project as well as traditional whole life policies.

The accumulation element in these policies is described as an "open architecture" structure, where all policy charges and credits are separately stated. The so-called "black box" of the traditional whole life policy has been (at least partially) opened up. However, in many universal policies, the carrier determines the interest rate credited on the policy, based on its average returns. In some universal policies, however, the rate is tied to an outside index.

Because of the disclosure of mortality charges and other expenses, no carrier can afford to let either get out of line for long; if they do, their healthy, well-advised insureds would presumably exchange their policies for other, more competitive policies issued by other carriers.

Note that universal life products levy back-end loads, for 10 or 15 years (on a decreasing basis), accounting for the difference between the accumulation and cash surrender value amounts. These loads are designed to discourage use of the accumulation element in the policy as a money market fund.

Also note that the policy will lapse if the accumulation value won't cover the current expense and mortality charges, unless the insured pays an added premium. Most policies show maximum mortality charges; actual mortality charges may be (and generally are) lower.

These are also general account products; as such, the policy accumulation account values are subject to the claims of the carrier's creditors.

One of the defining features of universal life policies is the flexibility the policyholder has to determine the frequency and magnitude of premium payments, subject to minimum policy maintenance (being sure there is always

enough in the accumulation account to pay mortality charges and other expenses) and the maximum TEFRA policy guidelines to keep the contract within the definition of life insurance under Section 7702 – a very large range.

Most carriers suggest payment of the "planned" or "target" premium. Agent commissions are generally based on this amount; paying more than these amounts into the contract may therefore produce a higher return, since these extra amounts aren't reduced by commissions. These premium descriptions are another way of saying pay what you want, but this amount should (not will), based on current assumptions (which can and will change), keep the policy in force to life expectancy. Note that the industry pushed regulators to be able to use another description for these payments, but regulators required its continued use; the continued use of that word arguably has led to confusion about the flexibility insureds have in deciding how much to pay in a given year, and to the mistaken concept that paying the suggested amount each year will guarantee the policy's long-term viability.

Premium payments can be changed from time to time (increased, decreased, or even skipped), within those broad guidelines, without prior notice to or the approval of the carrier.

In addition to the ability to borrow against policy values, the owner may also withdraw amounts from the policy, by making partial surrenders – tax-free up to basis (assuming the policy is not a MEC). Withdrawals are not loans; therefore, they don't require repayment, and no interest is charged on them (but, of course, there is less in the accumulation account to earn interest). Note again that there

are surrender charges in early years in many such policies, to prevent the accumulation account from being used like a savings or money market account, and that withdrawals may reduce the death benefit.

With universal life, in addition to changes in the non-guaranteed part of the crediting rate, changes can also occur in the non-guaranteed expense and mortality charges. For example, a universal life product might not perform as initially expected, even though interest rates remain constant, because the carrier raises the non-guaranteed expense and/or mortality charges assessed against cash values (but not in excess of the guaranteed mortality charge).

In this era of continually declining interest rates, some carriers have apparently been increasing the cost of insurance charges in their universal life policies, even though their mortality experiences have been improving, not deteriorating, as a way of making up for the loss of earnings they have been experiencing, especially in policies where the guaranteed rates exceed their current earnings.[5]

The ability of an insurer to do so may depend on the contractual language dealing with this issue. One carrier describes in its policies that the cost of insurance will be determined based on its expectations as to earnings, mortality experience, persistence (lapse rates), expenses and taxes.

Many universal life products now offer a form or a "no lapse" guarantee, under which the insurer guarantees that the policy will stay in force, regardless of whether there is cash value to support the policy, as long as a certain premium is

5 See, however, In re Conseco Life Ins. Co., C10-02124 SI (2013), a Federal District Court case, approving settlement of cases where the plaintiffs argued Conseco could not raise its cost of insurance without proof its mortality costs had increased.

paid, every year during the insured's lifetime, on time. These products may offer "no lapse" guarantees of varying durations, ranging from 20 years to the life of the policy. Some carriers offer separate no lapse policies, while others offer no lapse riders on traditional universal life products.

What the no lapse guarantee policy adds to a traditional universal life design is a so-called secondary guarantee (i.e., in addition to any guarantee provided under the policy with respect to crediting rates, mortality costs, or expense loads) – that if a certain premium or premiums are paid each and every year, as specified in the contract, the policy will not lapse (even if there is no cash value to support it). These policies therefore mimic "permanent term" policies, with fixed premiums, for life.

While these so-called secondary guarantees can make universal life products appear to be attractive alternatives to whole life, some commentators feel they may be unnecessary if the product was carefully selected, the carrier remains strong, both the owner and the agent are willing and able to monitor the policy, and the client is willing and able to react to future changes in the policy.

These commentators point out that these policies take away much of a universal life policy's flexibility, since the guarantee provision requires timely payment of fixed premiums every year and restricts (or eliminates) the owner's ability to withdraw from or borrow against the cash value; they also argue that traditional universal life products can be made to mimic term insurance for life, by careful premium payment adjustments. They also point out that these policies will build cash values more slowly than traditional universal life policies (or will not build

cash value at all), and aren't indicated where access to or the availability of cash values is a goal or having the flexibility of a policy with cash value is seen as important.

Finally, they note that the reserving that must be done for these policies by the carrier is so onerous that premiums on new NLG policies are rising, some carriers no longer offer them, while other carriers have introduced hybrid NLG products, with shorter guarantees and greater cash values.

For Universal Life policies, where the crediting rate is declared by the carrier, policy management suggests that the owner review the "typical" in-force illustration with the current funding premium, current expenses, and currently declared crediting rate. If the policy is 8 - 10 years old or older, the crediting rate is likely to be the guaranteed rate (4% prior to ~ 2003, 2% or 3% thereafter), and there should be no expectation that the crediting rate will ever be higher.

If the policy does not illustrate to "last" to an acceptable age (life expectancy plus 5 years), then request a recalculation of sufficient funding premium to life expectancy plus 5 years at current rate / current expenses.

Most carriers cannot illustrate anything between the current expenses and guaranteed expenses. Unless or until it's apparent that the carrier is starting to exceed its originally projected expenses, generally don't use the guaranteed expenses in an illustration request, unless the owner/trustee wants to review a "worst case."

C. Equity Indexed Universal Life Policies (EIUL or IUL Policies).

A number of insurers also offer equity indexed universal life policies, in which the crediting rate is determined not by interest earned by the carrier, but by reference to the performance of an equity index (perhaps the S&P 500, excluding, however, its dividend component), but with a minimum guaranteed crediting rate and a maximum crediting rate cap – a floor and a ceiling. Here, the policy owner gives up some part of the upside potential of the equity markets for downside protection.

In order to be able to provide both a floor and a ceiling on the crediting rate, the insurer uses some part of the policy account (perhaps as much as 10%) to invest in an index straddle – put and call options on the selected index.

These are not variable life insurance policies, as discussed below, since the policy owner does not have any discretion about how the policy cash values are invested (and cannot change investment strategies); they are still general account products for carrier creditor purposes, but do give the policy owner at least indirect access to the equity markets – trading the possible unlimited upside of market returns for some downside protection. Finally, like variable policies, these are expensive policies to administer, because of the hedging required to be done by the carrier.

In 2011, there was a shift to the purchase of indexed policies. EIUL policies are often illustrated at high rates—such as 8 percent—to show the potential upside of having such a policy. But 8 percent is an unrealistic crediting rate on policies today. Moreover, most agents typically illustrate the 8 percent as a constant return

over many decades, which is a “hoped for” investment impossibility aimed at winning a beauty (sales) contest.

Because there’s a minimum return guaranteed regardless of the index performance, there’s also downside protection. However, the high assumed rate of return can mask high expenses and mortality costs, so to get a better idea of how the product will really perform, potential policyholders should ask for an illustration assuming a 4.5 percent or 5 percent rate of return.

EIUL policies are very profitable to insurance companies, but they are the most difficult policies to understand of all the permanent-type policies available. Insurance companies often use simplistic explanations to describe EIUL policies, which don’t tell the whole story and many insurance agents aren’t adequately trained to understand the product’s nuances.

For Equity Indexed Universal Life policies, where the crediting rate is determined by an independent index, policy management suggests that the owner follow the process described above for universal life policies, but request an in-force illustration with the current funding and current expenses, and no more than 5.5% assumed gross crediting rate (5% to be safely conservative).

If the policy doesn't illustrate to "last" to life expectancy plus 5 years at a minimum, request a recalculation at a sufficient funding premium with no more than 5.5% assumed gross crediting rate (5% to be safely conservative).

D. Variable Universal Life Insurance Policies (VUL Policies).

Variable policies are generally built on a universal life chassis, a hybrid of universal and variable life insurance policies, combining – some would argue – the best features of both.

These policies provide the multiple investment accounts and separate account protection of variable life for the accumulation element, giving the policy owner access to the equity markets for policy values and providing protection against carrier insolvency. They also provide the premium payment flexibility, death benefit options and withdrawal possibilities of universal life.

These are security-based policies for SEC purposes. The policy itself (or at least the funds offered under the policy) is a security, because the lifetime values and (in some cases) the death benefit are determined by the "investment" choices made by the policy owner among the "funds" – actually separate investment accounts managed by the insurer (or an affiliate or an independent money manager) – offered under the policy. Because of this, the SEC regulates policy illustrations, the policy owner receives a prospectus, etc.

Most such policies offer a broad range of "funds", including money market, stock, bond, balanced, etc. These "funds" aren't available, except as a part of a variable policy. Some policies use outside money managers to run these accounts, as "clones" of their own mutual funds. Some policies – in large cases – are private placement arrangements, where the policy cash values are "wrapped" around clones of a family's or a corporation's investments in securities.

These “funds” (except for the guaranteed interest account) are separate accounts, generally not subject to the claims of the carrier’s creditors in the event of insolvency. While this protection depends on the state law applicable to the carrier, most states (and many foreign jurisdictions) have such a law. The general accounts of the insurer into which premiums are paid and out of which death benefits are paid are not separate accounts, and, accordingly, are subject to claims of the carrier’s creditors.

There are complex diversification and investor control rules for variable policies, under the Section 817 Regulations and a series of private letter rulings, to assure that the policy owner doesn’t directly control the investments within the funds offered under the policy. Again, the owner can invest the policy cash value among the funds offered under the policy, not individual securities or investments held within those funds; accordingly, in retail, off-the-shelf variable policies, investor control is not an issue, since the owner has no power to influence the investments made in the funds. The investor control issue is especially an issue in private placement variable policies where, for example, the policy owner wants to add a favorite money manager to the fund mix under the policy.

The availability of one or more equity-based funds under the policy allows the policyholder access to the equity markets in which to invest policy values. On the theory that, over time, equity-based funds historically have out-performed interest-driven returns, these policies give the policy holder the potential for greater long-term returns on policy values, subject to the risks inherent in such investments. On that theory, investing inside a policy, as opposed to doing the

same investing outside the policy is especially important, since the policy value growth is tax-free (or at least tax-deferred). This is especially true for tax-inefficient investments, such as hedge funds or strategies that generate short-term gains, etc. In fact, the more tax inefficient the investment, the better a candidate it is for use inside a variable policy.

Lower capital gain rates and – especially – stock market volatility tend to make variable policies much less appealing.

The agent must meet NASD and state law licensing requirements, and a prospectus must accompany the proposal. The proposal format is dictated by SEC guidelines. Under those guidelines, cash values must be projected at a gross rate of 0% and at one or more other gross rates of compounded growth, none of which may be more than 12%, even if the carrier has results for funds offered under the policy exceeding 12%. Maximum mortality charges must be shown; current charges can be show as well.

Here, it should be clear that policy illustrations are just "what if" scenarios, which can't be relied on to predict future values – could any stock market investment return a constant 12%, for example, for 40 or 50 years? Again, re-illustration of these policies on an ongoing basis should be routine, to track their actual performance. These are the ultimate buy and manage policies.

As noted, there will be SEC registration costs and ongoing asset management fees, and there may be surrender charges in early years in these policies. Because of these costs, variable policies probably won't make sense if the cash values are intended to be invested in money market or GIC accounts in the long-run, which

may limit these policies to those clients whose risk tolerance matches the risks of the policy's equity-based funds. In addition, given those costs, for clients who want to do asset allocation for their policy values, it may make more sense for them to invest their variable policy amounts in one or more of the equity funds and to purchase a separate universal policy for asset allocation of their insurance portfolio to fixed income returns – this has been described as Macro, rather than Micro, asset allocation.

Here, the black box has been opened completely, since the policy values are beyond the control of the insurer – the policy funds are worth what they are worth; this is WYSIWYG in the insurance industry. In addition, the prospectus describes the internal mechanics of the policy in more detail than anyone should care about. Finally, the policy statements show all debits and credits to the policy, on a monthly basis, and again, this disclosure should put pressure on the carriers to keep their costs (including mortality) and fees competitive (or run the risk of losing their healthy insureds).

Again, many variable policies also allow a blend of base policy and term, as a way to reduce the premiums for the death benefit. Because of the investment risk inherent with such policies, any such blend will require even more careful monitoring than any other blended product.

The death benefit may vary with the policy's investment experience, but (at least in most policies) not below the guaranteed amount. A guaranteed death benefit – regardless of investment performance – can be an important feature in variable policies. The "cost" of that guarantee may be the payment of ongoing mortality

costs, for life, reducing the investment accounts by what is essentially a term charge.

The investment risk here is totally assumed by the policyholder, except for any guaranteed minimum death benefit. The cash values are not only not guaranteed, and not only may not increase as quickly as has been projected, they may in fact decrease (or go to zero) – depending exclusively on the investment performance (or lack thereof) of the fund(s) chosen.

But again note the assumption about the long-term performance of equities versus fixed income securities. That long-run potential however must be weighed against the possible loss of some – or even all – of the principal value in any given period, especially when policy value at that point in time (the ability to stop making premium payments, for example) is critical to the plan. This will mean that these policies will, more than any other, require ongoing monitoring, which should be provided by the agent as a part of his or her policy service.

Again, importantly, these are separate account products, for carrier insolvency purposes. But note again the funds not treated as separate accounts for this purpose, described above.

One way to compare variable policies to either whole life or universal life policies is to consider: the potential difference between portfolio yields and equity performance, over time (recognizing the inherent risk being taken for this potential); and the difference between general account and separate account status, for carrier insolvency protection.

For Variable Universal Life policies, where the crediting rate is determined by the investment returns in sub-accounts, policy management suggests the owner follow the process described above for universal life policies, but request an in-force illustration with the current funding, current expenses, and no more than 7% assumed gross crediting rate (6% to be safely conservative).

1. If the policy doesn't illustrate to "last" to life expectancy plus 5 years at a minimum, then request a recalculation of a sufficient funding premium with no more than 7% assumed gross crediting rate (6% to be safely conservative)

POLICY TYPE COMPARISONS I

POLICY TYPES & CONSIDERATIONS[6]

Life insurance products generally fall into two main classes - term and permanent. Each class has its own set of benefits, limitations, and variations.

TERM INSURANCE

Term life insurance, the most common form, does not have an investment or cash value component, with coverage typically terminating at the end of the designated term. Because the policy isn't permanent and has no cash value build-up, premiums tend to be lower than other forms of life insurance. Most term policies are issued as single life policies, as opposed to second-to-die policies. Annual, level, and group term policies are all variations of term life insurance, and many clients likely will have some familiarity with one or more of these products.

Level-Term. A level-term policy provides a death benefit for a set period of time, which can be specified based on the policy owner's needs. The premiums and death benefit remain the same for the length of the contract. Level-term, is frequently used for clients who need to cover expenses that may end after a specified number of years, such as expenses associated with the ownership of a company that the owner intends to sell.

Key Characteristics of Level-Term
• Provides coverage for a selected number of years generally up to (30). Coverage often can continue after the initial term but at much higher premiums to account to for the increased age of, and lack of updated underwriting information for, the insured.
• Longer terms generally equal higher premiums.
• Premiums are generally level for the policy term (although some policies may guarantee a level premium for only part of the term).
• Guaranteed death benefit as long as the premiums are paid.

6 Provided by the Association for Advanced Life Underwriting.

• Frequently allow conversion of policy into permanent insurance without additional evidence of insurability and at the original classification, but require an increased premium to reflect insured's current age and conversion within a specified timeframe (e.g., within first 5-10 years of the contract or before insured reaches a designated age). This option can be helpful if the insured has a change in health and/or becomes uninsurable during the term.

Level-Term Variations: Term policy options include:

- Decreasing Term. Decreasing term policies have level premiums but annually decreasing death benefits. The policy terminates when the death benefit reaches zero.
- Return of Premium Rider. Return of premium policies provide for the return of all premiums paid on the policy if the insured survives the payment period. This additional protection will usually increase premium costs.

Group-Term. Many employers include group-term life insurance coverage as part of their employee benefits package.

Key Characteristics of Group-Term
• Coverage is provided regardless of the health of the employee.
• Premiums for the first $50,000 of death benefit are deductible by the employer and not treated as income to the employee. Premiums for excess death benefits are taxable to the employee as income to the extent of the equivalent term cost. **(1)**
• Coverage generally terminates when the employee leaves the company. **(2)**

- ***When to Consider***: Term insurance generally is the lowest cost option for life insurance coverage and will be a good alternative for short-term or defined needs - possibly in certain family situations such as funding a post-divorce, fixed-term obligation, in a business setting to fund certain buy-sell obligations, or for key-man insurance on a key employee. As term policies do not accrue cash value and generally terminate after the

designated term, they typically will not satisfy the objectives of clients with long-term family legacy, retirement, or business succession plans.

PERMANENT INSURANCE

Permanent life insurance products are designed for long-term retention and can provide a death benefit for the lifetime of the insured (or until the policy "matures" - e.g., when the insured reaches age 120), assuming required premiums are paid. Unlike term contracts, permanent policies generally include a cash value component that accumulates income and investment growth. Typically, the policy owner can access the cash value through withdrawals or borrowing against the policy. This policy growth and access to policy cash value (up to policy basis **(3)**) are not subject to current income, capital gains, or net investment income tax under appropriate and long-standing tax laws and principles. (4) Whole, universal and variable universal life insurance policies are all common types of permanent insurance.

Whole Life. Whole life policies provide more conservative clients with a guaranteed death benefit combined with a cash value that grows over time to equal the face value of the policy upon maturity.

Key Characteristics of Whole Life
• Premiums are fixed and level for the life of the insured. The policy owner can put additional funds into the policy that can grow on a tax-deferred basis.
• Provides a guaranteed death benefit (as long as the premiums are paid).
• The policy's cash value grows at a guaranteed rate (although usually lower than interest rates that are generally available). However, the assets that support the cash value are part of the insurance provider's general account and are subject to the claims of the provider's creditors.

• Whole life contracts may provide for the payment of dividends, although actual payment is not guaranteed. Dividends can be accumulated, used to reduce future premiums or, pursuant to a term rider, used to acquire additional insurance coverage. Dividends can also be paid to the policy owner up to the policy owner's basis in the policy without being subject to tax.
• Cash values are used to offset the death benefit upon the death of the insured.

Variations. The rigidity of ordinary whole life policies as to premiums has generated a number of variations to add flexibility.

- Paid-Up Policy. Paid-up policies are priced much the same as ordinary whole life policies but have a shorter period during which premiums are paid. Once all of the scheduled premiums are paid, payment of the death benefit is guaranteed without additional premium payments regardless of the performance of the insurance provider or the payment of dividends.
- Graded Premium Life Policies. These policies start with lower premium payments that gradually increase over time, such as 10 or 20 years. The ending premium payments are higher than if all the premiums had been equal from contract inception. Graded policies allow individuals who are currently unable to afford level premiums to acquire a whole life policy at initial lower premium rates.
- Modified Premium Life Policies. These policies are similar to graded life policies, but instead of graduated payments over time, the payments are level for a period of time with a single large increase in the premium at a specified point (such as 10 or 20 years after the date of issuance). Again, the premiums after the

jump will be higher than if all of the premiums had been equal from inception of the contract.

- Single Premium Policy. Single premium policies require only one large premium to guarantee payment of the death benefit. However, such policies generally don't meet the standards set out in Internal Revenue Code ("**IRC**") § 7702A and are treated as modified endowment contracts ("**MECs**"). As discussed in *WRMarketplace No. 15-15*, different tax rules apply to MECs than to other life insurance contracts.
    - ***When to Consider***. Whole life coverage may make sense for conservative clients wanting fixed, predictable premiums, guaranteed benefits, and cash value accumulation.

Universal Life. Universal life insurance, developed as an alternative to whole life policies, provides more flexibility as to the timing and level of premium payments. Generally, this type of policy also includes a guaranteed minimum rate of return on the cash value.

Key Characteristics of Universal Life
• Permanent coverage for the life of the insured or for a shorter period selected by the policy owner.
• Cash values and death benefit can be determined at time of issue based on the needs of the policy owner.
• Premiums are adjustable and can be paid at any time and in any amount, subject to specified limits. Payments above insurance costs are credited to cash value.
• Cash values grow based on interest rates set by the insurer on a monthly basis that are typically guaranteed not to drop below a specified rate. Universal life policies generally do not pay dividends.
• Cash values can be used for premium payments, to increase the death benefit, or for withdrawals (subject to income taxes if withdrawals exceed policy basis).

- The death benefit is guaranteed only so long as there is sufficient cash value to cover the monthly charges (subject to variations noted below). The policy must maintain sufficient cash value to keep the policy in force.

- ***When to Consider***. Universal life may make sense for clients that need permanent insurance but want flexibility in premiums and death benefits, as well as competitive cash value accumulation. The clients should have the discipline to pay premiums as needed and understand that premium requirements may increase depending on the payments made and the carrier's interest crediting rates.

Variations: Universal life policies are highly customizable, including as follows (note variable universal life is discussed below):

- Guaranteed Universal Life. Guaranteed universal life policies add a secondary guarantee that maintains a policy in force at a level death benefit for the guarantee period even if the cash value drops to zero; provided, however, that certain minimum premiums are paid for a set period. The guarantee typically comes at the cost of accessible cash value and premium paying flexibility. Premiums cannot be skipped and must be paid on-time, or the guarantee may be lost. The lack of a significant cash value also can limit the client's options to replace the coverage in the future. In addition, low interest rates and other market changes have impacted the availability and cost of these policies.
    - ***When to Consider.*** These policies may be suited to clients concerned with providing liquidity at death and optimizing the death benefit relative to premiums paid, and for whom cash accrual, access to cash value and flexibility in premium payments is of minimal importance. However, these policies will be less well-suited to those who want the ability to adjust their plan in a few years to address any changes in family planning or tax laws.

POLICY TYPE COMPARISONS II

POLICY TYPES & CONSIDERATIONS[7]

Life insurance products generally fall into two main classes - term and permanent. Each class has its own set of benefits, limitations, and variations.

TERM INSURANCE

Term life insurance, the most common form, does not have an investment or cash value component, with coverage typically terminating at the end of the designated term. Because the policy isn't permanent and has no cash value build-up, premiums tend to be lower than other forms of life insurance. Most term policies are issued as single life policies, as opposed to second-to-die policies. Annual, level, and group term policies are all variations of term life insurance, and many clients likely will have some familiarity with one or more of these products.

Level-Term. A level-term policy provides a death benefit for a set period of time, which can be specified based on the policy owner's needs. The premiums and death benefit remain the same for the length of the contract. Level-term, is frequently used for clients who need to cover expenses that may end after a specified number of years, such as expenses associated with the ownership of a company that the owner intends to sell.

Key Characteristics of Level-Term
• Provides coverage for a selected number of years generally up to (30). Coverage often can continue after the initial term but at much higher premiums to account to for the increased age of, and lack of updated underwriting information for, the insured.
• Longer terms generally equal higher premiums.
• Premiums are generally level for the policy term (although some policies may guarantee a level premium for only part of the term).
• Guaranteed death benefit as long as the premiums are paid.

[7] Provided by the Association for Advanced Life Underwriting.

• Frequently allow conversion of policy into permanent insurance without additional evidence of insurability and at the original classification, but require an increased premium to reflect insured's current age and conversion within a specified timeframe (e.g., within first 5-10 years of the contract or before insured reaches a designated age). This option can be helpful if the insured has a change in health and/or becomes uninsurable during the term.

Level-Term Variations: Term policy options include:

- Decreasing Term. Decreasing term policies have level premiums but annually decreasing death benefits. The policy terminates when the death benefit reaches zero.
- Return of Premium Rider. Return of premium policies provide for the return of all premiums paid on the policy if the insured survives the payment period. This additional protection will usually increase premium costs.

Group-Term. Many employers include group-term life insurance coverage as part of their employee benefits package.

Key Characteristics of Group-Term
• Coverage is provided regardless of the health of the employee.
• Premiums for the first $50,000 of death benefit are deductible by the employer and not treated as income to the employee. Premiums for excess death benefits are taxable to the employee as income to the extent of the equivalent term cost. **(1)**
• Coverage generally terminates when the employee leaves the company. **(2)**

- ***When to Consider***: Term insurance generally is the lowest cost option for life insurance coverage and will be a good alternative for short-term or defined needs - possibly in certain family situations such as funding a post-divorce, fixed-term obligation, in a business setting to fund certain buy-sell obligations, or for key-man insurance on a key employee. As term policies do not accrue cash value and generally terminate after the

designated term, they typically will not satisfy the objectives of clients with long-term family legacy, retirement, or business succession plans.

PERMANENT INSURANCE

Permanent life insurance products are designed for long-term retention and can provide a death benefit for the lifetime of the insured (or until the policy "matures" - e.g., when the insured reaches age 120), assuming required premiums are paid. Unlike term contracts, permanent policies generally include a cash value component that accumulates income and investment growth. Typically, the policy owner can access the cash value through withdrawals or borrowing against the policy. This policy growth and access to policy cash value (up to policy basis **(3)**) are not subject to current income, capital gains, or net investment income tax under appropriate and long-standing tax laws and principles. (4) Whole, universal and variable universal life insurance policies are all common types of permanent insurance.

Whole Life. Whole life policies provide more conservative clients with a guaranteed death benefit combined with a cash value that grows over time to equal the face value of the policy upon maturity.

Key Characteristics of Whole Life
• Premiums are fixed and level for the life of the insured. The policy owner can put additional funds into the policy that can grow on a tax-deferred basis.
• Provides a guaranteed death benefit (as long as the premiums are paid).
• The policy's cash value grows at a guaranteed rate (although usually lower than interest rates that are generally available). However, the assets that support the cash value are part of the insurance provider's general account and are subject to the claims of the provider's creditors.

• Whole life contracts may provide for the payment of dividends, although actual payment is not guaranteed. Dividends can be accumulated, used to reduce future premiums or, pursuant to a term rider, used to acquire additional insurance coverage. Dividends can also be paid to the policy owner up to the policy owner's basis in the policy without being subject to tax.
• Cash values are used to offset the death benefit upon the death of the insured.

Variations. The rigidity of ordinary whole life policies as to premiums has generated a number of variations to add flexibility.

- Paid-Up Policy. Paid-up policies are priced much the same as ordinary whole life policies but have a shorter period during which premiums are paid. Once all of the scheduled premiums are paid, payment of the death benefit is guaranteed without additional premium payments regardless of the performance of the insurance provider or the payment of dividends.
- Graded Premium Life Policies. These policies start with lower premium payments that gradually increase over time, such as 10 or 20 years. The ending premium payments are higher than if all the premiums had been equal from contract inception. Graded policies allow individuals who are currently unable to afford level premiums to acquire a whole life policy at initial lower premium rates.
- Modified Premium Life Policies. These policies are similar to graded life policies, but instead of graduated payments over time, the payments are level for a period of time with a single large increase in the premium at a specified point (such as 10 or 20 years after the date of issuance). Again, the premiums after the

jump will be higher than if all of the premiums had been equal from inception of the contract.

- Single Premium Policy. Single premium policies require only one large premium to guarantee payment of the death benefit. However, such policies generally don't meet the standards set out in Internal Revenue Code ("**IRC**") § 7702A and are treated as modified endowment contracts ("**MECs**"). As discussed in *WRMarketplace No. 15-15*, different tax rules apply to MECs than to other life insurance contracts.
    - ***When to Consider***. Whole life coverage may make sense for conservative clients wanting fixed, predictable premiums, guaranteed benefits, and cash value accumulation.

Universal Life. Universal life insurance, developed as an alternative to whole life policies, provides more flexibility as to the timing and level of premium payments. Generally, this type of policy also includes a guaranteed minimum rate of return on the cash value.

Key Characteristics of Universal Life
• Permanent coverage for the life of the insured or for a shorter period selected by the policy owner.
• Cash values and death benefit can be determined at time of issue based on the needs of the policy owner.
• Premiums are adjustable and can be paid at any time and in any amount, subject to specified limits. Payments above insurance costs are credited to cash value.
• Cash values grow based on interest rates set by the insurer on a monthly basis that are typically guaranteed not to drop below a specified rate. Universal life policies generally do not pay dividends.
• Cash values can be used for premium payments, to increase the death benefit, or for withdrawals (subject to income taxes if withdrawals exceed policy basis).

- The death benefit is guaranteed only so long as there is sufficient cash value to cover the monthly charges (subject to variations noted below). The policy must maintain sufficient cash value to keep the policy in force.

- ***When to Consider***. Universal life may make sense for clients that need permanent insurance but want flexibility in premiums and death benefits, as well as competitive cash value accumulation. The clients should have the discipline to pay premiums as needed and understand that premium requirements may increase depending on the payments made and the carrier's interest crediting rates.

Variations: Universal life policies are highly customizable, including as follows (note variable universal life is discussed below):

- Guaranteed Universal Life. Guaranteed universal life policies add a secondary guarantee that maintains a policy in force at a level death benefit for the guarantee period even if the cash value drops to zero; provided, however, that certain minimum premiums are paid for a set period. The guarantee typically comes at the cost of accessible cash value and premium paying flexibility. Premiums cannot be skipped and must be paid on-time, or the guarantee may be lost. The lack of a significant cash value also can limit the client's options to replace the coverage in the future. In addition, low interest rates and other market changes have impacted the availability and cost of these policies.
    - ***When to Consider.*** These policies may be suited to clients concerned with providing liquidity at death and optimizing the death benefit relative to premiums paid, and for whom cash accrual, access to cash value and flexibility in premium payments is of minimal importance. However, these policies will be less well-suited to those who want the ability to adjust their plan in a few years to address any changes in family planning or tax laws.

- Indexed Universal Life. With indexed universal life policies, interest on cash values is linked to the percentage change of an index, such as the S&P 500, Dow Jones Industrial Average, or the NASDAQ 100. Rate increases are usually capped and rate decreases usually cannot go below a specified minimum. Guaranteed death benefits typically range from 10-30 years rather than for the lifetime of the insured.
    - ***When to Consider***. An indexed universal life policy may appeal to clients who do not want to invest directly in the market but are interested in tying rates of return to a market index and/or who are satisfied with giving up some potential "upside" in exchange for some "downside" protection and less volatility in returns.
- Increasing Death Benefit. Increasing death benefit universal life policies are structured to provide a death benefit equal to the face value of the policy plus the cash value. An increasing death benefit may help the benefit keep up with inflation.
    - ***When to Consider***. Clients who are concerned about the rising cost of living may be interested in this type of policy.

Variable Universal Life. Variable life, mostly seen today based on a universal life platform as variable universal life ("**VUL**"), expands the investment component of permanent life insurance policies and allows the policy owner to direct how the cash value will be allocated among a variety of investment options (subaccounts) provided by the insurance carrier, which are typically managed by third-party sub-advisors.(5) Thus, VUL policies combine the premium flexibility of a universal life policy with enhanced investment features.

The total policy cash value and/or death benefit will vary depending on the performance of the policy's subaccounts, increasing or decreasing based upon the success of the policy's

investments. Some VUL products may include a rider/option for a guaranteed minimum death benefit for a specified period of time (typically at an additional premium cost).

Additional Characteristics of VUL
• Premiums in excess of the cost of insurance are deposited into a separate account that can be invested in subaccounts offered by the insurance provider.
• The insurance provider's creditors cannot reach the separate investment account.
• Premiums are adjustable and can be paid at any time and in any amount. Payments above the cost of insurance are credited to the cash value.
• Cash values can be used to make premium payments. However, if premium payments are not made and the stock market drops, a larger portion of the portfolio may need to be liquidated to pay the insurance charges.
• Permanent coverage can be provided for the life of the insured or for a shorter period selected by the policy owner.
• Cash values and death benefit can be adjusted based on the needs of the policy owner.
• The death benefit is guaranteed only so long as there is sufficient cash value to cover the monthly charges and to keep the policy in force.

Variation — Private Placement Variable Universal Life ("**PPVUL**"): PPVUL is a highly-customizable VUL product that allows the contract holder to negotiate with the insurer regarding policy costs, death benefit payment options, premium due dates and amounts, etc. to tailor the policy specifically to his or her planning goals**.(6)** As PPVUL investment options may include non-registered funds, however, PPVUL can be offered only to accredited investors or qualified purchasers as described by the Securities Act of 1933.**(7)**

- ***When to Consider***. VUL products may appeal to investment-oriented clients who can heavily fund the policy, have a long-term investment horizon, and prefer maximum control over the policy's investments and cash value growth over guaranteed benefits.

ADDITIONAL POLICY OPTIONS - POLICY RIDERS

Riders can customize a policy to increase the policy's flexibility, modify certain provisions in the underlying contract, and address the client's specific needs. The terms and availability of riders vary among insurance providers. Some of the more common policy riders are listed below.

- A term insurance rider allows the policy owner to add more term insurance coverage to a permanent life insurance policy.
- A disability waiver of premium rider allows premium payments to be waived if the policy owner becomes disabled. The base policy will continue in force.
- A disability income rider provides the insured with supplementary income and a waiver of premiums if the insured becomes disabled.
- An accidental death benefit rider can provide for an increased death benefit (typically double the face value of the policy) in the event the insured's death is accidental.
- An accelerated death benefit rider allows a terminally ill policy owner to take advances against the death benefit under the policy while the insured is still living. If the advances meet the requirements of qualified viatical settlement payments, the advances may not be subject to tax**.(8)**
- A long-term care rider allows prepayment of a portion of the death benefit if the insured can no longer perform specified daily living activities and requires long term care.
- A cost of living rider provides for automatic death benefit increases to offset inflation.
- A guaranteed purchase option rider allows the policy owner to increase coverage on an annual basis without the insured undergoing additional underwriting. This-type

of rider may be useful in split dollar arrangements or to provide reduced-benefits during the initial years of the policy if the three-year estate tax inclusion period applies.

- An extended maturity rider allows the policy owner to extend the date upon which the policy would otherwise mature or expire.
- A policy split rider provides for the division of a second-to-die policy into two separate single life policies upon a specified event, such as divorce or changes in tax laws.
- A return of premium rider provides for an additional death benefit equal to cumulative premiums costs. This rider may also be of benefit when entering into a split dollar arrangement or when the three-year estate tax inclusion period applies.

APPENDIX 3

Attributes of Term and Cash Value Life Insurance Policies	**Appendix 3**[8]

[8] From the "Advisor's Guide to Life Insurance" RPPT Law Section of the ABA (2010).

Attribute	Term Life Insurance	Cash Value Life Insurance						
		Whole Life Insurance			Universal Life Insurance			
		Nonpar Fixed	Nonpar Current Assumption	Par	Generic	No-Lapse Guarantee	Equity Indexed	Variable
Overview								
✓ Primary Policy Appeal?	Guaranteed coverage for specific period and low premium outlay	Guaranteed lifetime coverage with all policy elements fixed	Guaranteed lifetime coverage, transparency, backed by conservative investments	Guaranteed lifetime coverage, backed by conservative investments	Flexibility, transparency, backed by conservative investments	Guaranteed lifetime coverage at low premium outlay	Flexibility, transparency, with limited equity-like returns and a guaranteed floor	Flexibility, transparency, with mutual fund returns
✓ Bundled or unbundled?	Bundled	Bundled	Unbundled	Bundled	Unbundled	Unbundled	Unbundled	Unbundled
✓ Contains non-guaranteed policy elements?	No, typically	No	Yes, via current interest credits and charges	Yes, via dividends	Yes, via current interest credits and charges	Yes, via current interest credits and charges for cash values; no for guaranteed coverage	Yes, via equity index changes and current charges	Yes, via market value changes and current charges
Death Benefits								
✓ Guaranteed	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No

Attribute	Term Life Insurance	Cash Value Life Insurance						
		Whole Life Insurance			Universal Life Insurance			
		Nonpar Fixed	Nonpar Current Assumption	Par	Generic	No-Lapse Guarantee	Equity Indexed	Variable
✓ Duration?	Fixed term	Life	Life	Life	Flexible, including life	Flexible, including life	Flexible, including life	Flexible, including life
✓ Adjustability of duration?	No	Not easily	Not easily	Not easily	Yes	Yes	Yes	Yes
✓ Death benefit adjustable?	No	No	Yes	Not easily	Yes	Yes	Yes	Yes
✓ Choice of level or increasing?	No, typically	No	Yes	Yes, via riders or dividends	Yes	Yes	Yes	Yes
✓ Builds cash values?	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
✓ Guaranteed?	n.a.	Yes	Yes, if not relying on non-guaranteed premium	Yes, except for illustrated cash values attributable to dividends	Yes, if funded to guarantees	Yes, if funded to guarantees	Yes, if funded to guarantees	No

Attribute	Term Life Insurance	Cash Value Life Insurance						
		Whole Life Insurance			Universal Life Insurance			
		Nonpar Fixed	Nonpar Current Assumption	Par	Generic	No-Lapse Guarantee	Equity Indexed	Variable
✓ Location and nature of underlying investments?	General account; bonds and mortgages	General account; bonds and mortgages	General account; bonds and mortgages	General account; bonds and mortgages	General account; bonds and mortgages	General account; bonds and mortgages	General account; bonds and mortgages and equity index call options	Separate account; fixed income and equity mutual funds
✓ Increased likelihood of lapse with adverse development in current assumptions?	No	No	No, unless relying on non-guaranteed premium	No, unless relying on dividends to fund	Yes, but can be managed with additional premiums	No	Yes, but can be managed with additional premiums	Yes, but can be managed with additional premiums
✓ Impact of changes in market value on cash value?	n.a.	None	Indirect and muted	Indirect and muted	Indirect and muted	Indirect and muted	Indirect and muted	Direct
✓ Policyholder control of fund allocations?	n.a.	None	None	None	None	None	Allocations to index account	Total

Attribute	Term Life Insurance	Cash Value Life Insurance						
		Whole Life Insurance			Universal Life Insurance			
		Nonpar Fixed	Nonpar Current Assumption	Par	Generic	No-Lapse Guarantee	Equity Indexed	Variable
✓ Policy loans available?	No	Yes	Yes	Yes	Yes	Yes, but will impact NLG	Yes	Yes
✓ Withdrawals available?	No	No	No	Yes, indirectly via surrender of PUAs	Yes	Yes, but will impact NLG	Yes	Yes
✓ Fixed relationship to death benefit?	n.a.	Yes	Yes	Yes	No	No	No	No
✓ High early cash values?	n.a.	No	Yes	No, typically	Yes, often	No	Yes, often	Yes, often
✓ Protected from claims of insolvent insurer's creditors?	n.a.	No	No	No	No	No	No	Yes

Attribute	Term Life Insurance	Cash Value Life Insurance						
		Whole Life Insurance			Universal Life Insurance			
		Nonpar Fixed	Nonpar Current Assumption	Par	Generic	No-Lapse Guarantee	Equity Indexed	Variable
Premiums								
✓ Flexible?	No	No	No	No	Yes	Yes, but need to manage NLG	Yes	Yes
✓ Ability to mimic any other policy type?	No	No	No	No	Yes	Yes	Yes	Yes
✓ Skipping premium payment possible?	No	Not easily	Not easily	Not easily	Yes	Yes, but will reduce NLG duration	Yes	Yes
✓ Effect if premium not paid?	Lapse	Paid via policy loan if APL elected, o/w lapse to NFB*	Paid via policy loan if APL elected, o/w lapse to NFB*	Paid via policy loan if APL elected, o/w lapse to NFB*	Nothing, smaller policy value	Nothing, but will reduce NLG duration and policy value	Nothing, smaller policy value	Nothing, smaller policy value

Attribute	Term Life Insurance	Cash Value Life Insurance						
		Whole Life Insurance			Universal Life Insurance			
		Nonpar Fixed	Nonpar Current Assumption	Par	Generic	No-Lapse Guarantee	Equity Indexed	Variable
✓ How to resume premium payments and full coverage after premium nonpayment?	Pay past due premiums and re-qualify for insurance	If under NFB, pay past due premiums and re-qualify for insurance	If under NFB, pay past due premiums and re-qualify for insurance	If under NFB, pay past due premiums and re-qualify for insurance	Payments optional; full coverage remains if sufficient value	Payments optional; full coverage remains if sufficient value	Payments optional; full coverage remains if sufficient value	Payments optional; full coverage remains if sufficient value
Mortality Charges								
✓ Guaranteed maximum mortality charges?	Yes	Yes	Yes	Yes, if mortality gains cannot be negative	Yes	Yes	Yes	Yes
✓ Can actual charges differ from those at policy issuance?	No, typically	No	Yes	Yes	Yes	Yes for cash value; no for NLG	Yes	Yes

Attribute	Term Life Insurance	Cash Value Life Insurance						
		Whole Life Insurance			Universal Life Insurance			
		Nonpar Fixed	Nonpar Current Assumption	Par	Generic	No-Lapse Guarantee	Equity Indexed	Variable
✓ Who determines mortality charges?	Insurer	Insurer	Insurer	Insurer	Insurer	Insurer	Insurer	Insurer
✓ Actual mortality charges disclosed to policyholder?	No, but, m premium may be near actual	No	Yes	No	Yes	Yes	Yes	Yes
✓ Volatility of mortality charges?	None, typically	None	Low	Low	Low	Low for cash value; none for NLG	Low	Low
Crediting Rates								
✓ Guaranteed mini- mum crediting rate?	n.a.	Yes	Yes	Yes, if investment gains cannot be negative	Yes	Yes	Yes	Yes

Attribute	Term Life Insurance	Cash Value Life Insurance						
		Whole Life Insurance			Universal Life Insurance			
		Nonpar Fixed	Nonpar Current Assumption	Par	Generic	No-Lapse Guarantee	Equity Indexed	Variable
✓ Can actual crediting rates differ from those illustrated at issue?	n.a.	No	Yes	Yes	Yes	Yes for cash value; no for NLG	Yes	Yes
✓ Who determines crediting rate?	Insurer	Insurer	Insurer	Insurer	Insurer	Insurer	Insurer and index	Actual investment return
✓ Actual rate disclosed to policyholder?	n.a.	n.a.	Yes	No, except for some insurers	Yes	Yes	Yes	Yes
✓ Volatility of crediting rate?	None	None	Low to moderate depending on allocation method	Low to moderate depending on allocation method	Low to moderate depending on allocation method	Low to moderate for cash value; none for NLG	Low to high depending on allocation	Low to very high depending on fund choice

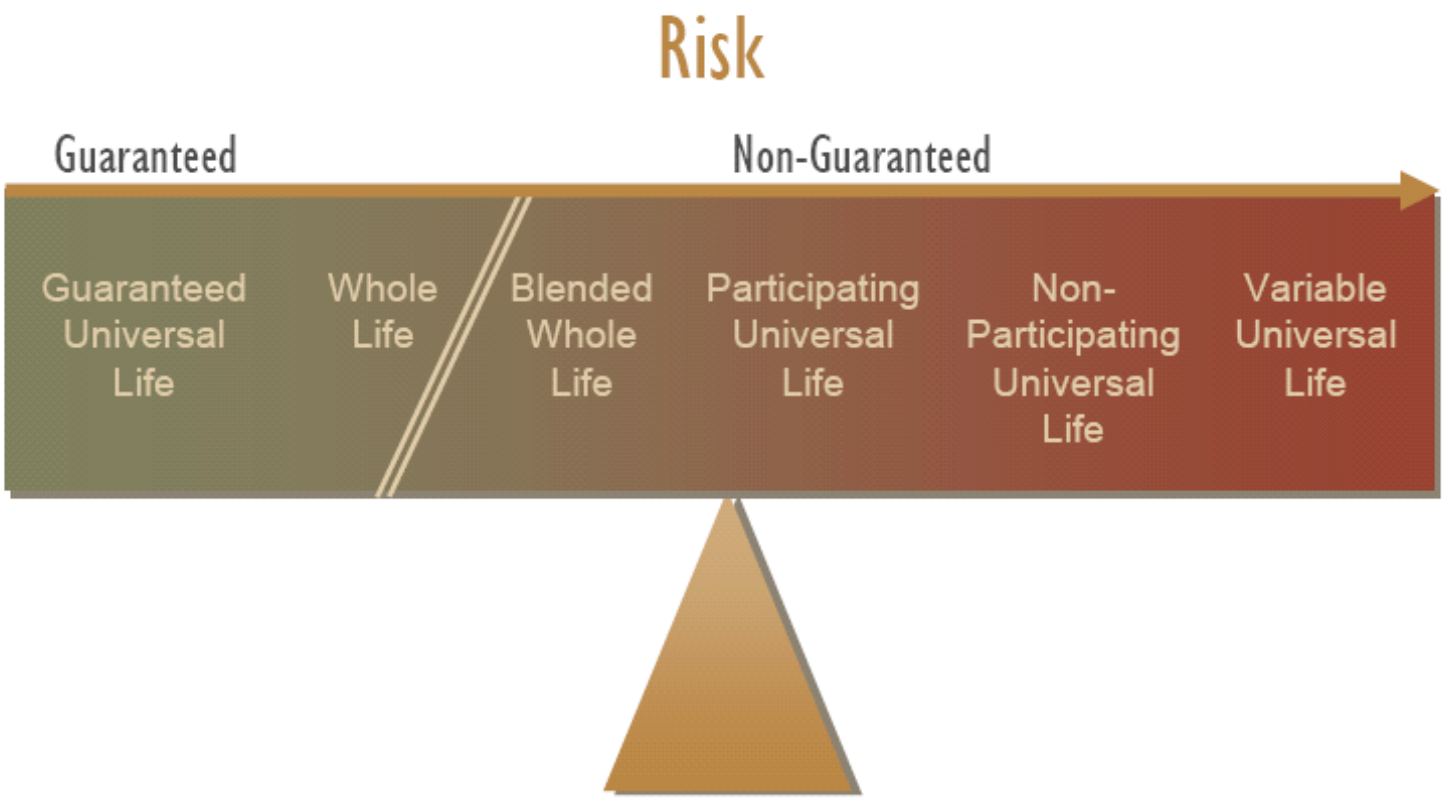
Attribute	Term Life Insurance	Cash Value Life Insurance						
		Whole Life Insurance			Universal Life Insurance			
		Nonpar Fixed	Nonpar Current Assumption	Par	Generic	No-Lapse Guarantee	Equity Indexed	Variable
✓ Crediting rate includes dividend income?	n.a.	n.a.	Yes, but modest	Yes, but modest	Yes, but modest	Yes, but modest	No	Yes
Policy Loading Charges								
✓ Guaranteed maxi- mum loading charges?	Yes	Yes	Yes	Yes, if expense gains cannot be negative	Yes	Yes	Yes	Yes
✓ Can actual charges differ from those illustrated at issue?	No	No	Yes	Yes	Yes	Yes for cash value; no for NLG	Yes	Yes
✓ Who determines loading charges?	Insurer	Insurer	Insurer	Insurer	Insurer	Insurer	Yes Insurer	Insurer

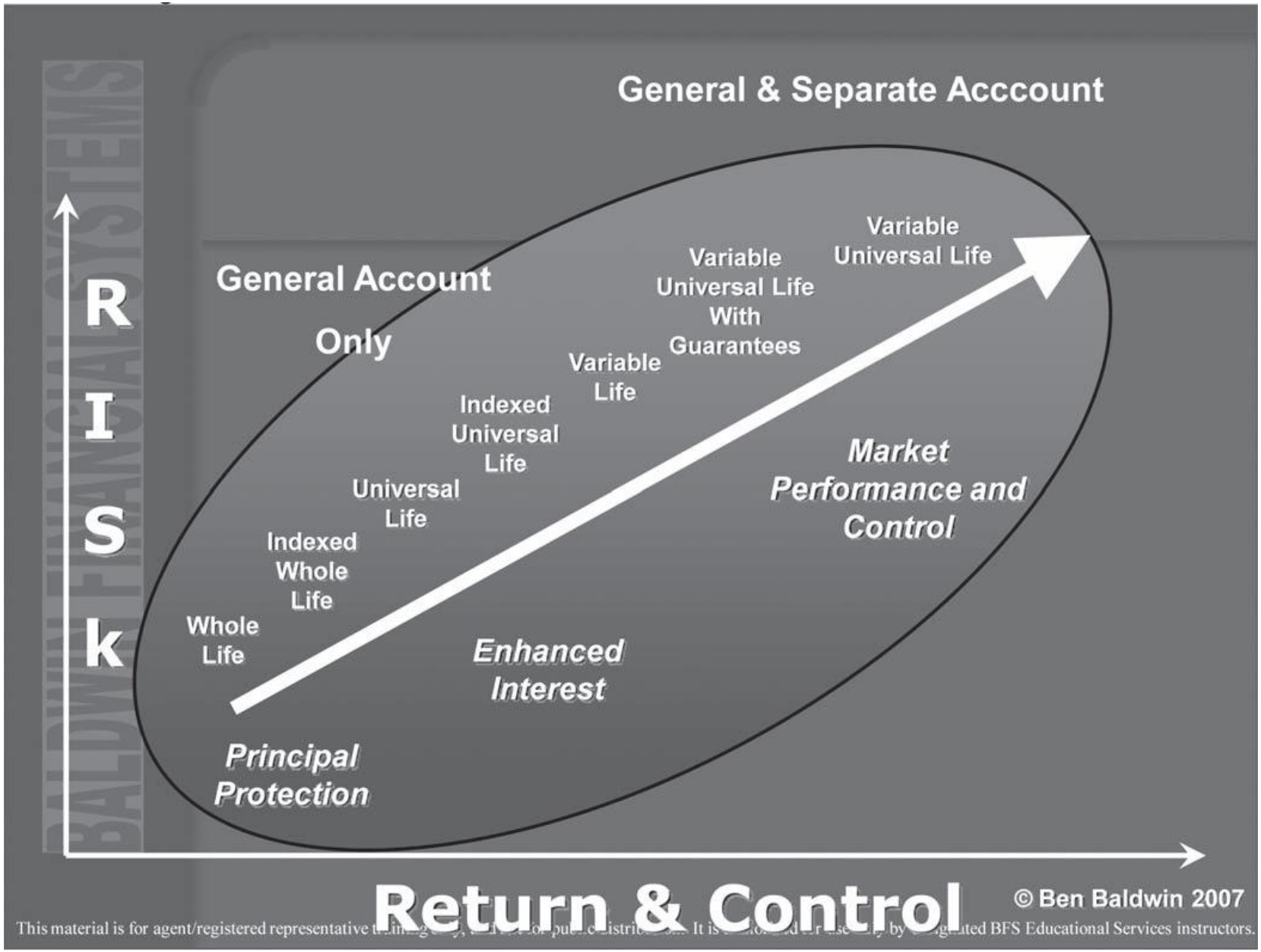
Attribute	Term Life Insurance	Cash Value Life Insurance						
		Whole Life Insurance			Universal Life Insurance			
		Nonpar Fixed	Nonpar Current Assumption	Par	Generic	No-Lapse Guarantee	Equity Indexed	Variable
✓ Actual loading charges disclosed to policyholder?	No	No	Yes	No	Yes	Yes	Yes	Yes
✓ Volatility of loading charges?	None	None	Low	Low	Low	Low for cash value; none for	Low	Low

* APL = **automatic premium loan**, an option offered by insurers whereby premium not paid within the grace period (typically 30-61 days following its due date) is paid automatically via a loan established against the policy cash value. NFB = **nonforfeiture benefits**, triggered when a premium is not paid within the grace period whereby the cash value is used to purchase either (1) **extended term insurance**, which is single premium term insurance in an amount equal to the policy face amount for whatever duration the cash value will fund or (2) **reduced paid up insurance**, which is single premium whole life insurance for whatever amount the cash value will fund. The automatic NFB ordinarily is extended term insurance. Reduced paid up can be elected.

POLICY INVESTMENT RISK COMPARISONS

Policy Risk Spectrum

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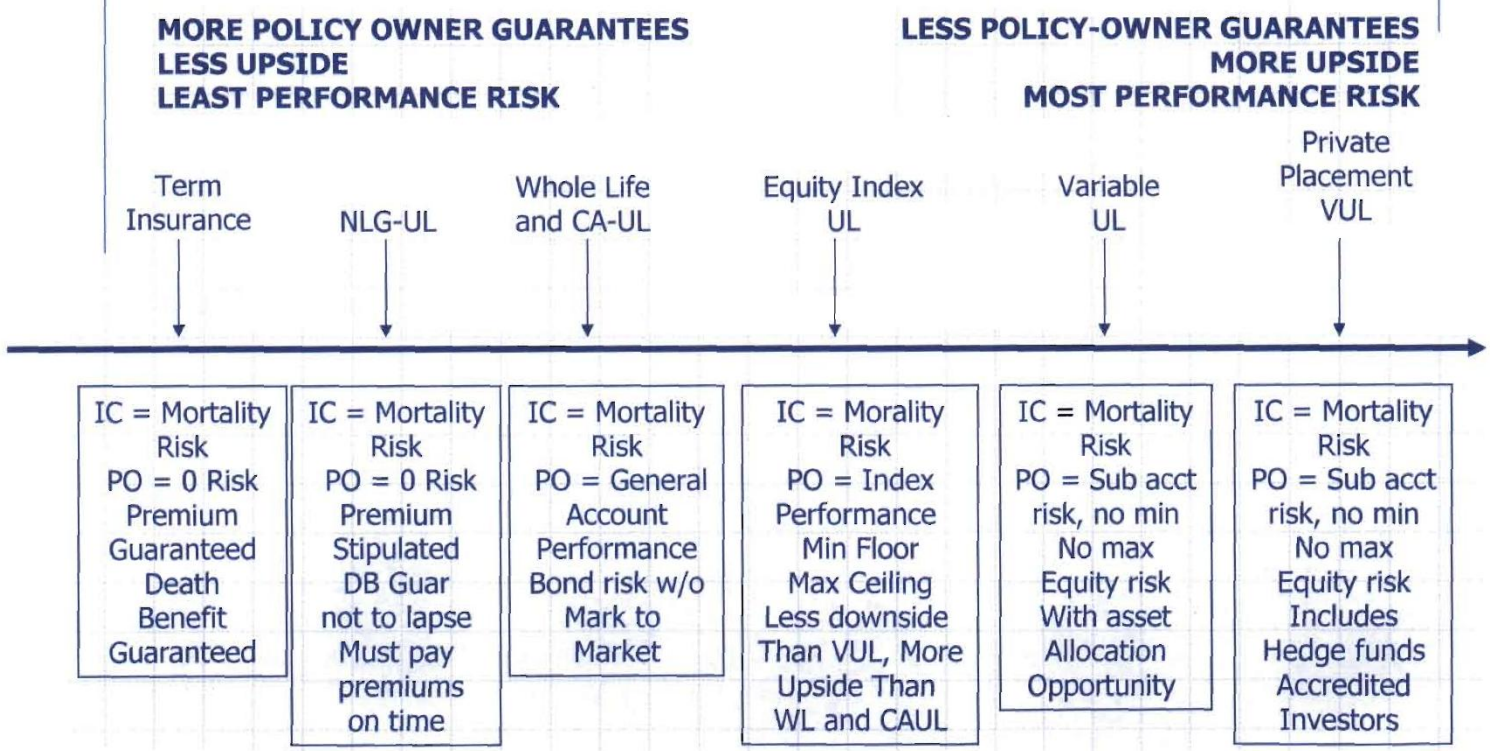
Design Criteria Risk Spectrum



Life Insurance Product—Risk Spectrum

High Product Performance Risk Full Market Exposure **High Product Risk**	***Hedged Product Performance Risk Limited Market Exposure***	***Reduced Product Performance Risk Carrier Portfolio Exposure***	***No Product Performance risk Guaranteed Results*** **Low Product Risk**
Variable Universal Life & Private Placement Life Insurance	*Indexed Universal Life*	*Universal Life & Whole Life*	*Guaranteed Universal Life*
• Cash values are "invested" in a basket at mutual funds. • Cash values are not subject to claims of carriers' creditors. • Policy owner takes investment risk, and performance is based on Investment performance. • Some carriers offer guaranteed riders that allow for both cash value growth and guaranteed premiums.	• Cash values grow based on a specified market index's return. • Cash values are not invested in the market; rather, a small portion buys call options on a specific index. • Carriers set cap and floor and offer guaranteed caps and floors. • Some carriers offer guaranteed riders that allow for both cash value growth and guaranteed premiums.	• Cash values are invested by insurance carrier in bonds and mortgages. • Cash values are subject to claims of carriers' creditors. • Crediting rates reflect "now money" rates • Carriers offer contractually guaranteed minimum crediting rates.	• Premium amounts and durations are guaranteed and are not interest sensitive. • In essence, it is term to age 100, with carrier taking more performance risk. • Policies designed to have less cash value. • Non-correlated to other assets. • Marketplace is shrinking and/or re-pricing.

"Mapping" the Client's Risk Tolerance to Policies[9]

Chief among the suitability factors as it relates to a long-term investment in life insurance should be the client's risk tolerance. Delineated into the classic labels of conservative, balanced, and aggressive, we can imagine risk tolerance statements related to the purchase of a life insurance policy being "mapped" or correlated to certain types of policies:

- "I'm intolerant of volatility and seek guarantees" is indicative of a conservative risk tolerance that can readily be mapped to policies that are guaranteed - such as **whole life, guaranteed death benefit universal life,** and even **term life** insurance for its initial guaranteed timeframe.

- or -

- "I'm tolerant of modest volatility and willing to accept fewer guarantees in favor of *premium payment flexibility"* indicates a more balanced approach in the context of paying for life insurance and would be the classic statement in favor of simple **universal life.** In this style of UL, the insurance company provides a minimum guaranteed crediting rate and, when possible and at its discretion, may credit to the policy a rate that is higher than its guarantees.

- or -

- "I'm tolerant of volatility and willing to do without guarantees in favor of *premium investment opportunity"* is indicative of an aggressive risk tolerance - and could map to the suitability of **variable life** insurance, in which the policy owner has the right and the obligation to determine how her premiums will be invested amongst an array of proprietary as well as institutionally offered mutual fund-like sub-accounts.

- or -

- "I'm intolerant of volatility but drawn to the idea of an *upside opportunity with no downside risk."* This somewhat convoluted risk statement best applies to the newest (and currently most popular) form of universal life - **Indexed universal life.** In contrast to the classic risk tolerance category of "aggressive" in terms of comfort with risk, I (somewhat tongue-in-cheek) refer to the risk tolerance associated with Index UL as Passive Aggressive. To the initial confusion of all but the most experienced investor, these policies are extremely complex, yet offer the seemingly simple assurance of upside opportunity when referenced stock market indices are positive, with no downside risk when indices are negative. Yet it is generally not well understood that ongoing policy expenses exert downward pressure on the account value. This is most dramatically demonstrated in newer **IUL** policies, which typically assess significantly higher expenses

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[9] Also provided by Richard Weber.

that in turn diminish account values when the index credit is low or "0" when reflecting negative returns in the measured index.

What approach to recommendations amongst an array of these policy choices could be more sensible than correlating risk tolerance to an initial consideration of policy style? While financial planners normally recommend the customized allocation of resources in a portfolio of investment categories by addressing their client's *conservative, balanced,* or *aggressive* risk tolerance, it is rarely seen in the life insurance sales process.

Consideration of Risk Tolerance Within Policy Types

There are further considerations of risk that might not be obvious within each category of insurance policy and the client's assessed risk tolerance:

1. **Whole Life** (Conservative): premiums, cash value, and death benefits are guaranteed, and cash values "lock in" as soon as they are credited. Dividends are not guaranteed until paid. Premiums are not flexible and in order to receive the substantial guarantees of the policy, the premium must be paid every year.

2. **Guaranteed Death Benefit Universal Life** (Conservative): while these policies typically develop little or no long-term cash value, premiums and death benefits are guaranteed as long as all scheduled premiums are paid on time. While both whole life and guaranteed death benefit policies have the advantage of requiring little or no active management, it must be pointed out there is a minimum premium indicated that guarantees (if paid timely) continuing coverage to a specific age such as 95, 100, even 110 or older. It is possible to change the paid premium once the policy is in effect, but that will almost certainly change the duration of the no-lapse guarantee. Still, the client has flexibility to some extent to pay more or less than the scheduled "no lapse" premium, which in most recently issued policies will accordingly drive the no-lapse age up or down.

3. **Universal Life** (Balanced): the insured with this risk style accepts policy elements that are not guaranteed, and buyers should be made aware that policy illustrations cannot reasonably predict ongoing planned premiums, potential cash value accumulation, or future policy loans - for more than a year or two at a time. As stated by the Society of Actuaries, "Most illustration problems arise because illustrations create the illusion that the insurance company knows what will happen in the future, and that knowledge has been used to create the illustration."[4]

   Hence, unlike policies whose main elements are guaranteed for the life of the policy, there is inherent risk in universal life policies in exchange for payment and timing flexibility. For traditional universal life, the major risk arises due to the initially illustrated planned premium turning out to be insufficient to maintain the policy over the insured's lifetime because anticipated crediting rates are not realized and/or policy expenses are raised higher than assumed in the original sales illustration.

4. **Variable Universal Life** (Aggressive/Very Aggressive): similarly, individuals with this risk style accept policy elements that are not guaranteed, and for which there are *no* guarantees as

to cash value accumulation. This is the one form of universal life in which the policy owner has both the privilege and the obligation to choose from mutual fund-like sub-accounts and inform the insurance company how she wants her premium payments "invested" across a wide spectrum of returns - from guaranteed to aggressive. Yet, variable policies are not as many critics have suggested - inherently risky. Sub-accounts may be deployed as an expression of the buyer's risk tolerance and materialize into a sophisticated asset allocation appropriate to that buyer.

Again, those for whom variable policies are suitable should be made aware that policy illustrations cannot reasonably predict ongoing planned premiums, potential cash value accumulation, or future policy loans for more than a year or two at a time.

Similar to its traditional UL cousins, there is inherent risk in the variable form of universal life. But because there is no floor to the crediting rate of the policy (i.e., when sub-account values are "down" - the crediting rate is negative), VUL policies will not likely cover a normal life expectancy for which the initial planned premium was calculated at (constant) rates of return in excess of 7%. Yet federal regulation of such policies allows projection rates as high as 12% and there is no practical impediment to the agent/Registered Representative using such a high assumed crediting rate with which to correspondingly project a low planned premium. This is unfortunately consistent with the insurance purchasing paradigm emerging from early universal life sales in which PRICE (planned premiums driven down by the assumption of high initial crediting rates persisting forever) became the sole determinant of VALUE.

It bears mentioning there can be a significant disconnect between the assumed crediting rate in the VUL sales illustration (projecting a constant 8% or 10% or 12%) and the returns in the sub-accounts designated by the policy owner that are *actually* deployed on behalf of the policy. A best practice approach to illustrating VUL is to address in advance the risk tolerance/asset allocation issues *before* any attempt to run a sales illustration, and of course the assumed crediting rate in the illustrated sales illustration must reflect a reasonable expected return from the assumed allocation. Further, as it is likely the insured's risk tolerances will change as he/she grows older, it is equally important to *manage* the VUL policy as to asset allocation adjustments and, in turn, an assessment of the need to increase the planned premium to compensate for a lower return expectation from less volatile (but reduced return) sub-accounts.

As with all forms of universal life, insurers may assess policy expenses that are higher than assumed in the original sales illustration, creating an additional impact on illustration expectations.

5. **Indexed Universal Life** (Passive Aggressive): especially as to a recent, second "generation" of product development within indexed UL policies, there is a high likelihood that illustrated projections cannot be met with respect to planned premiums, accumulated cash value, and the potential for large, illustrated cash value loans to supplement retirement income. Future imposition of policy expenses greater than implied in the sales illustration - and adverse movements in future index crediting rates, participation rates and caps - are also an element of uncertainty.

Additionally, there is a great deal of complexity beneath the surface of 1UL in how these policies are managed by the issuing insurance company. The insurer deploys hedging techniques to enable a "capped" crediting rate of 10 or 11% in an "up" stock market year, yet the investments underlying the policy's guarantees are not in stocks, but rather in high grade bonds and mortgages. Also, there is an almost total conceptual disconnect between the simplicity of the illustrated promise of "zero is the hero" (reflecting the guarantee that the crediting rate will not be less than 0%), and the amount of risk the buyer is taking to achieve the illustrated result. Net surrender values *can* be negative even when the segment credit is 0% because expenses will *always* be subtracted from account values, and enhancements and/or multipliers may also have specific expense that will be subtracted from account values regardless of the segment's crediting rate.

As is the case for all styles of universal life, it is important to assess the client's risk tolerance when it comes to selecting a *funding* level. Because the dominant benefit of universal life is "pay what you want / when you want," we must also assess the client's level of discipline when it comes to the discretion of paying flexible premiums. This is different from risk tolerance as to the basis on which policy credits will be earned, but the ability to commit to a specific planned premium is equally critical to the successful management of life insurance for its ultimate objective of death benefit and/or future cash flow from the policy.