The Policy Review: Ensuring Clients Don't Outlive Their Life Insurance (Part 2)

It is a basic principle of life insurance that in order to receive a death benefit, the policy must actually be a valid, in-force contract at the time of death. Yet despite this absolutely crucial aspect of life insurance - that if you want the death benefit, the policy must be "alive" at least as long as you are - the overwhelming focus of life insurance planning occurs at the time it is bought/sold, not in the years (or decades) that follow.

In last month's newsletter, we began a 2-part series exploring how to evaluate the health and anticipated longevity of a life insurance policy itself, when it is already present in the form of an existing, in-force contract. In this month's issue, we continue the process, looking specifically at the unique issues that arise when dealing with the most "flexible" forms of insurance coverage, including universal and variable universal life policies.

This month's content will hopefully help you develop a better understanding of the questions to ask, issues to watch out for, and options that may be available when dealing with universal and variable universal life coverage, to ensure that the policy is at least as healthy as the client, so that the client does not unintentionally outlive their insurance protection!

About the Author

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Introduction

Life insurance is a fundamental pillar of risk management in financial planning; it provides the financial means to deal with the financial impact that a death can have on a family (or business, or charity). In existence in some form for centuries, life insurance currently is available in a variety of different policy types, each of which has its own uses, nuances, and challenges.

Nonetheless, most policies can be broken down into a similar structure for evaluating the financial aspects of the policy. Although the pieces are more transparent for some policy types than others, ultimately virtually all product types are some combination of: 1) cost of insurance charges; 2) fixed administration/overhead expenses; 3) cash-value-based "wrap" fees (at least for most permanent policy types); 4) premium loads (charges on incoming premiums to the policy); and 5) interest/earnings credited to the cash value or the assets underlying the cash value (for permanent policies).

In last month's newsletter, we examined how these costs are expressed on an ongoing basis in term and whole life insurance policies; although there is some complexity involved, the policies still have a relatively simply underlying principle: as long as (typically level) premiums continue to be paid, coverage continues (either guaranteed for the duration of the term, or for the insured's whole life).

However, the entire chassis on which universal and variable universal life insurance is built is different; in the case of the latter types of coverage, it is not enough to simply pay some level premium for life, as duration of the policy is not based solely on the regular contribution of a particular premium. Instead, a deeper analysis is required, especially because problems not addressed early on can be incredibly expensive to "fix" later.

Universal Life

Background

The universal life policy represented another step in the evolution of permanent life insurance beyond the whole life policy with a non-forfeiture guaranteed cash value, and is best viewed in the context of the environment that created it - the rising inflation and interest rate environment of the 1970s (and early 1980s).

Up until that point, the dominant (and indeed, "only") form of permanent insurance coverage had been the whole life policy, with its somewhat modest - but guaranteed 'return' - annual increases in cash value. However, as interest rates rose, life insurance companies began to lose a great deal of business. Prospective policyowners became significantly less interested in the guaranteed but modest rates of return embedded into whole life policies (although to be fair, participating whole life policies would have enjoyed additional, albeit non-guaranteed, returns via dividends), compared to the interest rates available on then-current bonds (even guaranteed government bonds). In addition, with a typical whole life loan interest rate of "only" 8%, many existing policyowners began to borrow extensive amounts from the insurance companies with their whole life policies pledged as collateral, just to reinvest the proceeds into another interest-bearing account that would generate more yield, putting further pressure on the cash holdings of the life insurance companies (and since the policy was still in force, the policyowner might also still enjoy significant policy dividends to help manage the cost of the loan). The insurance companies wanted to offer an alternative that would allow policyowners to earn a higher rate of return on cash value of the policy, but without locking themselves into guarantees that could last for 50+ years (for a young person buying a whole life policy). The solution: a universal life policy with fewer guarantees than traditional whole life, but with a structure that allowed for a floating rate of interest being credited to the cash value, that could be kept in line with the current interest rate environment.

The basic chassis of a universal life policy is a cash value pool of money, which is used to maintain the costs of the life insurance coverage. Unlike a whole life policy, where premiums are required every year and the cash value is simply the non-forfeiture value guaranteed to be maintained even if the policy lapses, with a universal life policy the cash value *is* the focal point for supporting the policy itself. Expenses for the policy, including both the raw cost of insurance charges, and any/all policy administrative costs, are subtracted from the cash value. As long as there is enough cash value to cover the current month's expenses, the policy remains in force; if there is not enough cash value to pay for the upcoming month's costs, the policy lapses. Premiums themselves are flexible and can be made, or not, in whatever increments the policyowner wishes (and any premium loads for Federal or state insurance company taxes or other costs are simply netted against the premiums as they are contributed to the policy). Since the long-term permanence of the policy is now based on the presence of sufficient cash value to cover expenses, rather than the actual premium payment itself, policyowners have to make their own decisions about whether, how much, and at what frequency, premium contributions will be made.

In any event, the cash value of the policy ultimately is increased by any premium payments made into the policy (less any upfront charges applied to premiums), and the cash value is further increased by whatever interest rate of growth is credited to the policy. The interest crediting rate is set by the insurance company, fluctuates with (and generally stays in line with) current interest rates, and typically has some relatively low minimum guaranteed rate, such as 3% (albeit a minimum that in today's environment, may actually be rather appealing for many clients). However, while the cash value of the policy rises with incoming premium deposits and interest growth credited to the policy, it is depleted by monthly costs for the administrative expenses of the policy and the cost of insurance charges.

Administrative expenses vary by the policy, but typically include some level of fixed expenses for overhead, and may include a charge that is a percentage of the cash value. Typical total administrative costs for a universal life policy may vary from less than 1% to upwards of 2% of the cash value of the policy (sometimes higher for very small cash values where the overhead expenses constitute a proportionately larger share of the cash value).

On the other hand, cost of insurance charges are based on the "amount at risk" to the insurance company - the difference between the current cash value, and the face amount of the policy, which represents the amount of death benefit that the insurance company is "on the hook" for, in the event that there is a death of the insured. Cost of insurance charges are typically priced based on the cost for $1,000 of coverage at the insured individual's current age, and then is multiplied by

however many thousands of dollars of coverage is required for the amount at risk; for example, if the cash value is $44,000 and the death benefit is $500,000, then the amount at risk is $456,000, and the cost of insurance charge might be $0.15 per $1,000 of insurance coverage each month, resulting in a total cost of insurance of $0.15 x 456 (thousands) = $68.40/month (in addition to any policy administrative expenses). As the insured ages, the cost of insurance per $1,000 at risk might rise higher than $0.15 per unit of coverage, and as the cash value rises (with growth and premiums) or falls (if costs exceed incoming premiums and interest growth), the amount at risk will change as well. In practice, this is why cost of insurance charges are applied on a monthly basis in a universal life policy; because the factors change on an ongoing basis as the cash value fluctuates and age increases.

As mentioned earlier, unlike the whole life policy, ongoing premiums are not required to maintain universal life coverage; it simply remains in force as long as there is sufficient cash value to cover ongoing expenses. However, because the cost of insurance for the amount at risk rises as the insured ages, universal life insurance policy costs can become increasingly expensive as the years pass, especially in the later years of life. Accordingly, while it is not required to pay ongoing premiums into the policy, it is often advisable, especially in the early years when policy costs are low (because the cost of insurance charges are typically low, even though there may be a significant amount at risk); this allows the policy not only to build enough cash value (especially with interest growth exceeding costs in the early years) to be capable of supporting costs in the later years, but also increases the cash value to be closer to the face amount, reducing the amount at risk on which insurance charges are applied. (Editor's Note: Under the tax law rules that determine what constitutes "life insurance," there must always be some gap between the cash value and the face amount so that there is some amount of insurance at risk for the insurance company; consequently, if the cash value rises too fast and gets too close to the face amount, the death benefit will typically automatically increase to maintain a "corridor" of coverage between the cash value and amount paid at death.)

Thus, in practice, while the whole life policy is a guarantee-based product - you pay the premiums, you're guaranteed to continue coverage, with a guaranteed cash (non-forfeiture) value to boot - the universal life policy is flexible but also uncertain, and its outcome depends on the policyowner's voluntary

Secondary Guarantee UL Coverage

One of the major developments in Universal Life over the past decade has been the offering of UL products with so-called "Secondary Guarantees" attached to them. The secondary guarantee typically states that as long as a certain specified premium is paid, the policy is guaranteed not to lapse, regardless of cash value. In this manner, the secondary guarantee UL policy becomes something much closer to the whole life policy, which similarly guarantees coverage as long as the specified premium is paid. The difference with the secondary guarantee UL, though, is that the policyowner CAN choose to pay a different/lower premium - or no premium at all - and the policy will simply revert back to the standard UL policy, which remains in force (regardless of premiums) as long as the cash value is sufficient to support ongoing policy costs. Perhaps the bigger difference, though, is that while secondary guarantee UL policies do guarantee the death benefit - i.e., that coverage won't lapse - as long as premiums are paid, it makes no guarantees about the cash value of the policy itself, which may or may not perform favorably.

In terms of premiums, the required payment amount for secondary guarantee UL policies is typically somewhat less than what is required for whole life coverage, but is usually still a very substantial premium relative to term insurance. While the cash value is not guaranteed at any particular level, some guaranteed UL products will nonetheless accumulate cash value (simply because premiums plus growth exceed expenses), while others may leave little if any cash value by deliberate design. Notably, though, because insurers must hold reserves for both paying future death benefits and providing current cash value that can be demanded at any time, and higher reserves for an insurer generally equate to lower profitability (or a "need" to assess higher charges to maintain profitability), products without cash value can actually offer lower costs and thus require lower premiums. Notwithstanding this, in some situations cash value will still accumulate, due to the significant contributions that must be made to secure the secondary guarantee; it's just not certain exactly how much will accumulate, given the lack of cash value guarantees and the portions of universal life costs and interest crediting rates that can still fluctuate over time.

In practice, secondary guarantee UL coverage is currently very popular. It ensures a guaranteed death benefit for the duration of the guarantee (often, for life), allowing the policyowner to have permanent policy coverage for life, but at a lower cost than paying for whole life. In exchange, the policyowner should be cognizant, though, that there is no particular guarantee regarding cash value, which could even be depleted entirely in the future.

decisions to pay premiums or not, and earn whatever interest rate is credited over time. In fact, one might simply view a universal life policy as "a tax-deferred interest sensitive investment vehicle for paying ongoing term insurance costs" since that is a close representation of how it functions in practice (where the "term insurance costs" are simply the annual cost of insurance charges on the amount at risk, plus administrative expenses).

On the other hand, the uncertainties of universal life policies - which come in exchange for the flexibility - also mean that such coverage often requires far more attention and maintenance, as modest differences in premiums, insurance charges, or other policy factors can have a dramatic impact on the long-term sustainability of a policy. Deviations from the original projections of the policy are further exacerbated by the fact that underperformance of the policy leads to lower cash values, which increases the distance to the face amount and therefore the amount at risk under the policy, which in turn results in higher total insurance costs and causes the cash value to underperform projections even further. Unfortunately, universal life policies have a high risk of cascading into an unsustainable policy with unmanageable costs if they are underfunded and/or underperform, especially if there is not an active monitoring process to correct problems early.

Questions To Ask About Ongoing Universal Life Policies

The starting point for the evaluation of the universal life policy is similar to whole life, or really any other insurance policy: what was the intended purpose of the policy in the first place.

Beyond taking some time to understand what the purpose of the coverage, the next questions to ask are focused on delving into the basic details of the policy (most of which can be determined from the Policy Declarations page, which is typically one of the first pages of the insurance contract itself), and might include:
- Who is the policyowner?
- Who is the insured?
- Who is the beneficiary?
- What is the face amount?
- What was the underwriting classification (preferred, standard, etc.)?
- When was the policy issued (and how old was the insured at that time)?
- Will there be a charge for surrendering the policy?

In addition, because the universal life policy is not guaranteed, and instead is entirely dependent on the long-term viability of its cash value (plus ongoing contributions and growth) to support the insurance costs for the long run, additional questions pertaining to universal life policies should include:
- Are premium contributions being made to the policy, and if so in what amounts and at what frequency?
- What is the cash value?
- What interest rate is being credited to the cash value of the policy? (And what is the lowest minimum interest rate that may apply?)
- Is there a loan? If so, what is the balance, and what is the loan interest rate?
- What was/is the purpose of the loan?

It is also important to understand the expenses coming out of the policy, such as the cost of insurance charges, fixed administration expenses, premium loads, etc.; planners should at a minimum request an in-force ledger from the insurance company, showing a projection of the policy's cash value and death benefits using various cost and performance assumptions.

On the other hand, universal life policies with so-called "secondary guarantees" (see sidebar, prior page) may in fact have no-lapse guarantees to protect the policyowner in the event that the cash value is depleted by the expenses of the policy, but not all guarantees work the same. Thus, for universal life policies, it's also important to understand:
- Does the policy have some form of secondary guarantee?
- What ongoing payments are required for the secondary guarantee to apply?
- How long must the payments continue for the guarantee to apply? Is there a maximum age for payments?
- How long will the secondary guarantee continue to apply? Does the guarantee extend "for life", or only to a certain maximum age?
- Is the secondary guarantee actually still in force?
- Have all premium payments been made since the policy was issued to comply with the secondary guarantees?

Next Steps with Universal Life

In the case of universal life policies, evaluating the ongoing health of the policy is more complex than simply evaluating term insurance or whole life. With the latter policy types, at the end of the day, the coverage continues as long as premiums continue to be paid, and the only exceptions are (potentially) at the end of the term for term coverage, or if there is a growing loan that

compels the whole life policy to be surrendered as collateral to pay off the loan. Short of those situations, though, the questions for term and whole life typically focus on what might happen at the end of the time horizon, or how to deal with loans and dividends; the focus is not the underlying long-term viability of the coverage itself.

Universal life coverage, on the other hand, is different. In the case of UL policies, there are no guarantees that the coverage continues (short of secondary guarantee UL where the required premiums are maintained). If the policy runs out of cash value, it lapses, and at that point the only way to "save" the policy is to pay the monthly policy costs directly (i.e., deposit enough in premiums to cover ongoing costs, or deposit even more to try to build the cash value growth again). Unfortunately, though, in a manner similar to sustaining cash flows from a retirement portfolio, because the policy cash value (account balance) is intended to support the policy expenses (withdrawals) for decades on end, even small deviations in return sequence (growth) or costs (withdrawals) in the early years can be magnified into a collapsing cash value balance that lapses the policy in the later years. And because the cost of insurance charges are based on age (and thus are very high in the later years at older ages), delays in correcting an underperforming policy in the early years can result in spectacularly high premium demands to maintain the policy in later years. Trying to maintain a universal life insurance policy in the later years when it has no cash value is quite literally analogous to buying an annual term insurance policy for an elderly individual; suffice it to say, it can be remarkably expensive as a last resort for coverage.

Consequently, regular reviews of universal life coverage are crucial, far more so than with other types of life insurance coverage. Policies can deviate from their original projections very materially over time, even if ongoing premium deposits are made exactly as

Third Party Insurance Analysts

Universal life provides some unique challenges when evaluating existing policies, because projections are complex and not guaranteed, which means in practice it's very difficult to identify which in-force illustrations are conservative versus optimistic versus outright unrealistic. Certainly, planners can look at the illustration to see if the policy cash value is spiraling downwards towards a lapse, but if it is not lapsing, is that because the policy is healthy and well-funded, or because the non-guaranteed current projections happen to be overly optimistic?

Fortunately, help is available. In the same way planners can and do often subscribe to Morningstar and similar services for pricing and performance research on investments, so too are similar services emerging to evaluate pricing and performance on (especially permanent) life insurance products. The notable leader in this space is www.TheInsuranceAdvisor.com; more information at info@TheInsuranceAdvisor.com.

In addition, there are now a number of third party insurance analyst firms available to help other financial planners and their clients evaluate an existing insurance policies, to understand whether the projections are realistic and whether there are any concerns embedded in the illustrations that may not be readily apparent.

Although this is by no means an exhaustive list, here are a few individuals/companies to contact if you're looking for more assistance analyzing a client's existing life insurance policy (in alphabetical order by company name):

- Joe Maczuga, Fee Advisors Network, www.feeadvisorsnetwork.com, FeeAdvNtwrk@aol.com. *Services*: Provides a process that follows fiduciary standards; the foundational center piece of Life Insurance Fiduciary Ethos; the Life Analyzer for providing reverse engineering capacity along with historical market cycles; and a transparent presentation that educates in easy to understand fundamentals of policy style functionality.

- Glenn Daily, www.glenndaily.com, gdaily@glenndaily.com. *Services*: Keep/replace decisions for existing policies. Policy selection for new coverage. Contract review to determine optimal premium schedules. Policy valuation for life settlements.

- Brian Peterson, NextGen Advisor, www.nextgenadvisor.com, brian@nextgenadvisor.com. *Services*: Insurance consulting firm specializing in working with fee-only and fee-based advisors, performing analysis, implementation (when required), and ongoing annual reviews.

- Bob Cohen, Tamar Fink, www.tamarfink.com, cohenb@tamarfink.com. *Services*: Identification, analysis, and solutions for mispriced and underperforming life insurance policies. Practice is exclusively dedicated to life insurance industry and life insurance planning solutions.

The insurance analysts above utilize various business models to serve other financial planners; you can view information on their services via their website and reach out to them directly to explore further.

originally planned, due to fluctuations in the interest crediting rate and the fact that the insurance company can change several underlying policy expense costs (up to a certain maximum limits specified in the policy) many years after the coverage is originally purchased. Consequently, premium payments that were originally projected to maintain the policy to age 100 can thus turn out to result in a lapse at age 80 or 90, or extend to age 110 and beyond, because of shifts in policy costs and actual investment experience. Regular reviews (at *least* once every few years) are crucial to be aware of problems early, when they are the least expensive to correct (i.e., when cash value can be increased with new contributions while there's still time to reduce the amount at risk and achieve a larger cash value base for future growth).

As indicated in the earlier questions section, the first step to getting a handle on the health of a current UL policy is to obtain an in-force ledger illustration directly from the insurance company, to see how the policy projects at current premiums and rates, as well as what could happen at maximum costs (if the insurance company chooses to raise them that high). Planners can explore using tools such as www.policypricingcalculator.com to evaluate whether the costs are reasonable relative to industry peer group averages, since from a practical perspective, most planners will have little grounding to understand whether the costs are "reasonable" given the coverage being provided (i.e., most planners would not otherwise know if a cost of insurance charge of $0.15 per $1,000 of amount at risk is or isn't reasonable for a client at age 35, or 45, or 55). Nonetheless, evaluating costs are important, given the wide disparity in product pricing where the difference between competitively- and poorly-priced products can as high as 40% or even 80%; in such situations, it may make little sense to put ongoing premium contributions into an underfunded policy if it is very poorly priced (unless there is no option for replacement due to a change in health of the insured). Details on policy costs, including all the various fixed administrative expenses and loads, can be found printed in the life insurance policy contract itself.

It is important to bear in mind that deviations from original projections may not only be a result of investment results that differed from expectations, but also because most insurance companies have flexibility under their own universal life policies to change (i.e., raise) many of the cost of insurance charges themselves. Insurance companies are often inclined to do this because when the company issues a new policy, it prices cost of insurance charges based on the known health of the insured (when underwriting had just occurred). The longer the policy remains in force, though, the less the insurer knows about the health of the insured, and consequently insurers may choose to charge disproportionately more for cost of insurance charges in older policies than in newly issued ones to compensate for the increased uncertainty. For example, the cost of insurance charges for a 60-year-old client may be lower on a new policy insuring that 60-year-old, than a policy issued when the insured was age 40 that has been in place for 20 years. This practice of charging more in cost of insurance charges for insured individuals under older policies than similarly aged insureds under newly issued policies is called Select and Ultimate pricing, and can actually be an incentive to replace current UL coverage if costs are reviewed and are no longer competitive (and if health still allows a new policy to be underwritten favorably). This can be especially appealing given the flexibility under the tax code's section 1035 to exchange the cash value from an existing universal life policy to a new one on a tax-deferred basis.

It may also be desirable to request a second policy projection at a crediting rate that is higher or lower than the current rate offered by the company (depending on the view you have about interest rates relative to what the policy currently pays), to understand the implications of interest rate shifts. Unfortunately, though, while it is relatively easy to examine the future impact of varying crediting rates of return for the policy, most insurance illustrations give little flexibility to show the impact if the insurance company varies the *policy* costs, aside from the column showing guaranteed maximum charges. To the extent the future may end out somewhere between the "current" expenses and the "guaranteed maximum

Out and About

- Michael will be speaking about "Advanced Concepts and Issues in Long-Term Care Insurance Planning" at FPA Central Pennsylvania on April 19th

- Michael will also be presenting "Tax Update: 2 More Years" at the FPA Central Pennsylvania meeting on April 19th

- Michael will also be speaking about "Rethinking Risk Tolerance at the NAPFA NC/SC Study Group meeting on April 21st

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expenses," any in-force policy projections still entail some uncertainty. In addition, if the current interest rate appears to be wildly out of whack with the current return environment (which may happen), there is an increased risk that the crediting rate may be dropped in the future, even if rates otherwise remain level or go slightly higher; after all, the crediting rate is still determined at the discretion of the insurance company, which might be offering an "artificially" higher rate now to induce contributions or retain business, but may lower the rate in the future. Ultimately, the interest rate credited to the policy should be reasonable and sustainable in relation to the historical performance of the assets that underlie the insurance company's own portfolio (generally, a very bond-heavy portfolio with only a modest allocation to equities). If there appears to be any danger that the policy might lapse - or perhaps, even if there's not - it may be desirable to engage a third party insurance analyst to further evaluate the cost projections and interest rate assumptions embedded in the UL projection to determine if they are reasonable, since such details are typically beyond the scope of the average planner.

Policies that are otherwise healthy - i.e., they have sufficient cash value that, with growth, they can cover anticipated policy expenses for life - can still get into trouble if there is a loan against the policy. This is because, as with whole life coverage, if the value of the loan grows to the point that it nears the cash value of the policy, the insurance company will cancel the insurance policy and use the cash value collateral to pay off the loan. (In addition, it is still true that if the insured dies with an outstanding loan, the death benefit proceeds will be reduced by the amount of the loan balance to pay back the insurance company.) However, unlike with whole life coverage, UL policies typically are not participating and generate no external dividend; consequently, once a loan balance exists for a UL policy, interest and/or principal payments can generally only be paid with outside dollars. Although payments don't have to be made - the loan interest can simply accrue further on the existing loan - it can become problematic later on if the accumulated loan balance becomes unmanageable. On the other hand, because UL policy premiums are flexible at the discretion of the policyowner, loans are not automatically incurred against the policy for non-payment of premiums as may occur with whole life policies. Instead, a loan against a UL policy usually represents a deliberate action by the policyowner to have extracted the loan - hopefully with a plan about if/whether/how it may be paid back!

While there are risks that policy loans can accrue with interest to the point that they threaten the viability of the policy, in reality universal life policies that are otherwise well funded can exist with a modest loan for an extended period of time, possibly the entire life of the policy. If the policyowner dies with an outstanding loan, the loan balance is simply paid off from the death benefit proceeds, with the remainder paid out to the beneficiary. However, given the long duration of a universal life policy - and the fact that, short of making external payments against the loan interest and/or principal, the loan balance will just continue to accrue - even relatively modest loans can become problematic over multi-decade time horizons. This can be especially true in the later years, when higher cost of insurance charges begin to have a material impact and slow the growth of the cash value. In the early years, it's not uncommon for the loan interest rate to be close to the policy's crediting rate - for instance, the loan accrues at 5% while the policy earns interest at 4.5% - and consequently, the growth in the collateral nearly keeps pace with the growth in the loan balance as insurance costs are modest. However, in the later years, the cash value's growth with a 4.5% interest crediting rate might be eroded by significant cost of insurance charges for an aged insured, and as a result the *net* growth of cash value begins to lag behind the growth rate accumulating loan balance, ultimately bringing the total loan balance close to the policy cash value putting the policy at risk of lapse.

As a result of these challenges, universal life policies with loans must be monitored even more carefully, and if there is a risk that accumulating loan interest may threaten the health of the policy in future years (assuming there is a goal to maintain the coverage), it may be desirable to direct additional outside dollars towards the policy sooner rather than later, either to pay the loan interest and reduce the growth rate of the loan, or possibly to extinguish some or all of the loan principal. Conversely, if (modest) ongoing loans are actually being taken intentionally - e.g., to generate cash flows for retirement - an annual monitoring process should be implemented to ensure the policy does not get off track. In addition, it may be desirable to request an in-force illustration showing several different crediting rates (e.g., 1%, 2%, or 3% higher and lower than the current rate) to get perspective on how reliant the current borrowing schedule is on getting favorable interest rate investment results. Unfortunately, in practice many policies used partially for retirement cash flows are in danger of lapsing if investment results (or internal policy costs) are just slightly less favorable than originally projected.

For policies that are already in trouble, options are often more limited. Strictly speaking, the policyowner can prevent a universal life policy from lapsing simply by paying the ongoing monthly costs of the policy (cost of insurance charges, plus other policy expenses), but this is generally not a feasible long-term plan to maintain the viability of a policy, especially in later years as cost of insurance charges rise sharply with advanced age. Paying ongoing costs out of pocket is usually only appealing if the insured has a very short anticipated time to live, where it may be worthwhile to maintain very high premiums - even out of pocket - to keep the coverage in force until death. If the policy is in trouble but the policyowner has not had a change in health, it may be more desirable to simply replace the policy with term coverage for whatever the remaining desired time horizon is, or determine a comparable premium deposit that might be made just to sustain the UL coverage for the desired time period, given that the policy is ostensibly not intended or going to run for life anyway. It is also notable that if there is a possibility of lapse, the policyowner should also be aware of the cost basis of the policy and if there is any potential gain, especially if the policy has a significant loan, such that there may be a large taxable gain even though there is little remaining net cash value after paying back the loan.

For policies that are not yet in trouble, but are projecting to have trouble down the road, there is a little more flexibility. Premium deposits may be increased currently, to try to build more of a cash value cushion so that future growth inside the policy can better maintain future insurance charges (and also to slightly reduce the amount at risk and therefore the current total policy expenses being extracted from the cash value). Any loans may be paid down, or paid off completely. Alternatively, the policyowner might consider reducing the face value, especially if the full amount of the coverage is no longer needed; this in turn reduces the amount at risk, and therefore the policy expenses, and can increase the longevity of the remaining coverage. If the policy is desired for life, and ongoing premiums are anticipated, it may also be worthwhile to investigate whether a replacement policy could be acquired with a secondary guarantee against lapse, especially if there has been no adverse change in health since the original policy was issued and the policyowner can manage the required no-lapse premium contributions.

In situations where the need for insurance is no longer permanent, policyowners may simply reduce or stop premium payments and allow the ongoing cash value to support the cost of insurance until the policy lapses of its own accord. Alternatively, it may be desirable to investigate a replacement term insurance policy for the intended limited time horizon, but if there is already a cash value build-up inside the policy - that is still earning tax-free growth - simply maintaining the existing universal life policy may be more efficient, and provides more flexibility in the future (the policyowner can always change his/her mind and continue the policy longer, it will simply require more premium contributions at some point in the future).

On the other hand, in situations where there is still a need and desire to maintain permanent coverage for life, any secondary guarantees that may apply should be evaluated to ensure proper funding to maintain the guarantee, and if there is no such guarantee, an overall healthy level of funding is crucial to the longevity of the policy. This may include running multiple in-force illustrations at varying rates of return, to fully evaluate the longevity of the policy in a variety of interest rate environments, and to make decisions about whether more or less funding is needed to maintain coverage.

In any event, the bottom line is that while UL offers far more flexibility on premiums and the opportunity to earn "market" rates of fixed-income returns on the cash value, its flexibility also entails significant uncertainty, increasing the burden of ongoing monitoring and review. An effective UL policy may provide a desired death benefit at a more favorable out-of-pocket cost than a comparable whole life policy death benefit, and/or may accumulate a greater cash value, but is also at risk to underperform and/or even lapse (or become unmanageably expensive) in later years.

Variable Universal Life

Just as universal life evolved as prospective policyowners wanted the flexibility to invest at current rates of interest instead of via whole life guaranteed returns, so too did variable universal life evolve (in the 1990s) as prospective policyowners wanted the flexibility to invest their cash value directly into the markets instead of being tied to fixed-income-style rates of return.

The underlying chassis of the variable universal life (VUL) policy is virtually identical to the UL policy, with one notable difference: instead of investing funds in the general account of the insurer and receiving whatever interest crediting rate is offered at the time, the policyowner has the choice to invest in sub-accounts

offered under the policy. The sub-accounts, which functionally operate similar to mutual funds, allow the policyowner to invest in a pooled fund with other policyowners, which is professionally managed by a third party. Because the price per share of the sub-account can and will vary with the returns of the market, it is referred to as a "variable" sub-account, and lends its name to the overall "variable" universal life policy label.

Because the underlying framework of the VUL policy is the same as a UL, the terms under which it lapses are the same: a VUL policy will terminate when the cash value is insufficient to cover the ongoing monthly expenses of the policy. Conversely, as long as the cash value is sufficient to maintain the expenses of the policy, the policy will remain in force, and the returns on the policy sub-accounts simply allow the cash value the potential to grow further, to support more future policy expenses.

Variable universal life policies typically have slightly higher administrative policy expenses than their UL counterparts, in addition to the fact that the sub-account investment options themselves have their own expense ratios, typically comparable to mutual fund equivalents. In exchange, VUL policyowners have the opportunity to invest in bond, stock, and other alternative investment options - whatever is offered under the insurance policy - and seek to grow the cash value at a higher net return.

Of course, the typical goal with a VUL policy is to generate those higher returns on the cash value - at least relative to a fixed-income-style UL policy - either to support future policy expenses, or to make the cash value available for other purposes in the future. For policyowners who want to maintain permanent insurance coverage for life, the VUL policy offers the opportunity to make lower premium contributions and allow a greater growth component to create the required cash value to support the policy for life. On the other hand, some will want to extensively fund the policy, so that cash value may be available in the future that loans can be taken against for other purposes (such as retirement income), while still maintaining enough cash value to support the policy itself.

Questions To Ask About Ongoing Variable Universal Life Policies

Because the underlying policy chassis for a VUL policy is still the same as a UL policy, any/all questions that applied in a UL context will apply for a VUL as well. Consequently, readers are referred to the earlier section on UL policies for initial questions to ask.

In addition to those preceding questions about UL-based policies in general, there are a few additional questions to ask regarding VUL policies, because of their investment options, including:
- What is the current allocation of the cash value amongst the investment sub-accounts?
- How are those investment sub-accounts performing and what are their costs?
- How are any new contributions to the policy being allocated amongst the sub-accounts?

Next Steps For Variable Universal Life

Given the similarities to traditional UL policies, the next steps for VUL coverage are similar. However, in practice, the VUL policy often requires even more active monitoring and maintenance, because the potential volatility of the cash value as it is invested presents the risk that a healthy policy can quickly turn into an unsustainable one.

As a result, it is prudent to run an in-force illustration for a VUL policy once every year or two, to keep vigilant about the health of the policy. The challenge is especially pronounced with a VUL policy, because not only can the internal policy expenses vary up to the guaranteed maximums at the discretion of the insurance company (as with UL coverage, including the impact of Select and Ultimate pricing on policies that have been in place for many years), but the volatility of the cash value itself is also a challenge. Volatility presents unique difficulties for VUL policies, because it not only impacts the cash value available to pay for ongoing policy expenses, but can actually indirectly (yet potentially very adversely) increase or decrease those costs as well because of how the amount at risk is calculated.

For example, if a VUL policy has a death benefit of $500,000 and has accumulated up to $200,000 of cash value, the policyowner pays for cost of insurance charges on $300,000 (the difference between the death benefit and cash value, which is the amount at risk for the insurance company) in addition to other policy expenses. If the policy, invested heavily in equities for long-term growth, experiences a significant short-term decline of 30%, the cash value drops to $140,000. This in turn causes the amount at risk to increase to $360,000, which means all else being equal, the cost of insurance charges will RISE by a whopping 20%

(paying for $360,000 worth of cost of insurance charges, instead of only $300,000) to cover the costs of the higher amount at risk. As a result, withdrawals of policy expenses to maintain the coverage will be higher - rising at the exact time that the cash value declines (in fact, *because* the cash value declined), exacerbating any setback and slowing the pace of a recovery. In other words, the policy expenses will actually force the liquidation of even more cash value during a downturn! Accordingly, an otherwise healthy policy can quickly reach a point of no longer being viable in the long term. (Of course, the opposite is also true when returns are favorable; the compounding of VUL volatility and its impact on the amount at risk can extend in both directions.)

A similar challenge can occur when there is a loan involved, because when a loan is taken from a VUL policy, the insurance company moves a portion of the cash value equal to the amount of the loan from the sub-accounts to a "loan account," to avoid investment risk and uncertainty regarding the value of the loan collateral. Consequently, for many policies, if the cash value was $100,000 and a $20,000 loan was taken, then $20,000 of the cash value would automatically be shifted from whatever sub-accounts were originally selected, into the loan account of the insurer, to ensure that the value of the loan collateral is not too volatile. Of course, the loan account does still earn a rate of return, and will continue to grow, but the loan account interest rate will be fixed-income level returns (and will generally be 25bps to 200bps lower than the policyowner's loan interest rate). Consequently, if the reality is that the policy's long-term projections were only healthy because they were predicated on a higher equity-based long-term rate of return, then a significant loan on the policy - pushing some of the cash value out of long-term growth investment options and into the fixed account - can diminish the overall long-term growth of the policy's cash value. This in turn means that an otherwise healthy policy with a loan can end out with a diminished long-term growth rate that results in a lower-than-anticipated future cash value and no longer be viable. This may be true even if the loan value itself never exceeds the cash value of the policy (which would automatically cause a lapse), simply because the policy cannot support cost of insurance and administrative expenses in the later years if the cash value never accumulates as high due to the lower growth rate of the fixed account. In addition, of course, the fact that the loan account will pay a lower interest rate than the policyowner is charged in loan interest means, at some point, the loan itself can still begin to overwhelm the policy, too.

Notwithstanding the fact that market volatility can be so problematic, unfortunately most in-force illustration software can't model such volatility very effectively. For instance, simply trying to show a 20% decline followed by a slow recovery, and the impact of that sequence of returns on the long-term health of the policy, is beyond the capabilities of most illustration software.

At the least, though, projections can be run using a broad range of high and low steady-growth returns. Accordingly, clients might request multiple in-force illustrations of a VUL policy, at a number of different long-term returns, such as 4%, 6%, 8%, and 10%, to begin to understand how sensitive the current policy is to varying rates of return. However, it is important to note that this does *not* fully replicate the impact of market volatility; as with sustaining retirement income, policies that generate the expected rate of return over time but do so with an unfavorable return sequence can still dramatically underperform relative to the original projections. In point of fact, the impact of return sequencing is actually worse for VUL policies than it is for most retirement withdrawals, because underperforming VULs actually incur *increasing* costs due to the rising amount at risk (and the associated cost of insurance charges) in a declining market. Accordingly, it is often difficult to illustrate many types of problem scenarios; most illustration software is limited to a "worst case" scenario of projecting 0% returns, yet in reality a sustained bear market - even followed by a recovery - can actually result in even worse performance. Nonetheless, viewing VUL illustrations at varying rates of return is at least a good starting point; some Monte Carlo simulation tools for VUL policies are also now becoming available, which can more accurately convey the impact of market volatility on the longevity of the policy in a variety of scenarios. Many of the aforementioned insurance analysts (see sidebar on page 5) also have additional tools to examine these challenges in greater depth.

For a policy that is currently in trouble, or projects to be in trouble in the future, the most common solution is the same for a VUL policy as it is for a UL policy - to increase premium contributions to help create enough cash value to maintain the policy, generate sufficient future growth, and get it back on track. Policies that are in danger in the near term may require significant contributions just to be maintained

Equity-Indexed Universal Life

Another new development for life insurance policies in recent years is the so-called "equity-indexed universal life" policy. Still built on a universal life chassis, the key differentiator for equity-indexed universal life is that it generates returns in a similar manner to equity-indexed annuities: by using a crediting formula that is tied to an index, calculated based on the terms and details of the contract.

For instance, the cash value of the policy might offer a return equal to 80% of the price change in the S&P 500 index (not including dividends), up to a maximum cap of 12% in a single year. If the price change is negative (i.e., the market declines), the contract simply provides a 0% return for the year and the cash value remains invested fully intact for the following year. As with equity-indexed annuities, the crediting formulas will often include some combination of participation rates (the percentage of the gain that is credited as return), caps (the maximum return that can be earned in the time period), and spreads (a subtraction from the gross return to arrive at the net return credited). Returns may be calculated using point-to-point (measuring the gross return between a price level from the start date to the end date), or some form of averaging formula (e.g., appreciation is based on the average monthly index level for the year over the starting price at the beginning of the year).

In practice, equity-indexed UL policies are often appealing to consumers for the same reason as equity-indexed annuities are - they promise the potential for at least a partial market upside, but ensure that there are no declines in a down market. Accordingly, the cash value returns feel less risky than variable universal life, but with more upside potential than traditional universal life's fixed-income-equivalent returns.

However, critics of equity-indexed universal life point out that in reality, the terms of the equity-indexed crediting rates - the participation rates, caps, and spreads - are funded by only a very, very limited portion of the dollars invested with the insurance company in the case of equity-indexed universal life. Because the premiums and cash values themselves must be invested in the insurer's General Account (as required by regulation) to support the cash value, only the interest earnings from investments - in excess of the guaranteed policy interest rate - are actually available for use to purchase options in the index upon which performance is to be based.

For instance, an equity-indexed UL policy is issued by an insurer that guarantees no investment losses (i.e., a 0.0% guaranteed interest rate), where the insurer's historical portfolio returns have averaged 5.0%/year in predominantly high-grade corporate bonds and government-backed mortgages, and the policy itself is projected to earn a 6% long-term return in the equity-indexed strategy. Accordingly, if the policy has $1,000,000 of cash value (that remains in the General Account), it is expected to earn $50,000 of interest, which will be invested in the equity-indexed options strategies, and must grow to $60,000 to generate a 6% total return. Notably, this means that the $50,000 must grow to $60,000, which is a whopping 20% return on the options strategies for the year, and must recur every year to maintain a 6% growth rate! If the policy is projected to grow at 7.5%, the options investing that produces the equity-indexed returns would have to *average* 50% per year to generate the projected growth rate given the limited dollars invested! Because of these limitations regarding the amount of money actually allocated to the equity-indexing portion of the policy, critics question whether the upside claimed by equity-indexed UL advocates is really feasible.

And notably, even if policies offer promising terms (participation rates, spreads, and caps) in the initial year(s) that appear capable of earning the projected returns, those terms can still be changed at will by the insurance company to something less desirable down the road. Furthermore, as years of underperforming UL policies have demonstrated, a policy can earn a positive return every year and still be at significant risk for lapse; it's not about losing money, it's just about underperforming the original projections (if not adequately funded). As a result, even if equity-indexed UL "can't lose money" with its guarantees, it may still not be viable in the long run.

In the end, this doesn't mean that equity-indexed UL policies are never appropriate, but it does mean that great caution is merited in projecting appropriate and feasible long-term rates of return, and funding the policy in a manner that will be viable in light of those projected returns.

further; policies that currently have sufficient cash value but are projected to deplete over time may require more modest adjustments. When a VUL policy is in trouble, it may also be a good time to evaluate the overall purpose of the policy in the first place, and whether permanent coverage is still needed. In addition, although less common, some VUL policies may also have secondary guarantees to ensure the coverage remains in force as long as a certain premium is paid, which can enhance the viability of an otherwise endangered policy, albeit at the "cost" of required ongoing contributions. And of course, if a VUL policy is in trouble, the investment sub-accounts themselves should also be reviewed, to ensure that the funds are performing reasonably (given their stated objective), and that the investment allocation is reasonable for the goals and purpose of the policy.

On the other hand, while market volatility via the sub-accounts can have an adverse long-term impact on a VUL policy if there is a precipitous decline, this doesn't necessarily mean that VUL policies should be invested very conservatively. If the policy's investments are too conservative, then the long-term net returns after policy expenses may not be any better than a fixed-investment UL policy with lower returns but lower policy expenses. Thus, the reality is that the VUL policy itself represents a somewhat riskier proposition, with more upside (in terms of higher cash value or lower premium contributions necessary to support the policy), but more downside (as policies could get a string of unfavorable investment results that force more premium contributions to get back on track). To say the least, a full due diligence review of the investment options currently selected and otherwise available under the policy is crucial when evaluating an existing VUL policy.

It's also notable that for many VUL policies, the intention of the policy is not just lifelong coverage, but to generate enough "excess" cash value that loans can be taken against the policy to supplement retirement income (and/or such loans may already be underway), without impinging on the long-term viability of the policy. If a VUL policy is heavily funded and actually gets favorable investment returns, this can be a viable strategy. However, VUL policies with ongoing loans present even more challenges, as the policyowner must now evaluate the investment allocation, the expected returns, if/whether any contributions are being made, the amount of the loan balance as it is projected to accrue, and the amount of additional loans that can be supported in future years without creating a problem. If such a policy is being reviewed, numerous illustration scenarios should be evaluated, with varying return assumptions and anticipated loan amounts. For instance, if the policy appears to be viable with the current anticipated loans, but lapses in 20 years when the rate of return is 1% lower, the loan strategy of that particular policy may be far riskier than initially realized.

Policies that are intended to accumulate significant and ongoing loans must be evaluated especially carefully, due to the fact that if the policy lapses, the entire loan balance is treated as part of the proceeds received, even if the net cash value (after loans) is near $0; in such scenarios, the policyowner thus may generate an incredibly large tax liability attributable to a significant amount of cumulative gains over the lifetime of the policy, even while having no cash value available to pay for the tax liability (because it was previously extracted in the form of loans). Because the tax liability applies if the policy lapses while the insured is alive, but not if the loan is paid off via a death benefit, proper maintenance of the policy (to ensure it stays in force until it matures as a death benefit) is crucial. Mistakes in this context can mean the difference between all cumulative loans for the lifetime of the policy being treated as a taxable gain (to the extent it exceeds cost basis) with a lapse, versus the loans turning out to stay tax free as the tax-free death benefit pays off the loan balance with the net proceeds (after repayment of the loan) flowing to the beneficiary.

In the end, VUL policies entail greater uncertainty about the future, due to both their opportunity to invest in more volatile but hopefully-higher-returning investment options, and the way return sequencing can impact the long-term health of the policy as the amount at risk on which cost of insurance charges apply will also vary over time (in addition to the possibility the insurer will raise cost of insurance charges themselves on older policies). This has been especially problematic for many VUL policies currently in force, as the last decade has in fact been a case-in-point example of a volatile environment with unfavorable return sequencing that may have significantly impaired the long-term viability of many VUL contracts, even if returns going forward from here are favorable and average out to the expected long-term return. As a result, while VUL policies can create strong opportunities in favorable return environments, they also require the greatest depth and effort for ongoing monitoring, especially in the type of investment environment of recent years. This can be even more crucial if systematic loans are anticipated or are actually being taken, to ensure that the policy remains viable for the long run and does not cause an undesired and unexpected loss of death benefit - and a potential tax catastrophe with loans - due to lapse.

Summary/Conclusion

Life insurance is a risk management pillar of financial planning, yet in reality we have a tendency to focus more on life insurance decisions at the time of initial need and purchase - how much to buy, what type of policy, what are the premiums, etc. - with often very little follow-up in the ongoing years (and decades!) thereafter that a policy remains in force.

For some types of coverage - like term insurance - not a great deal of ongoing monitoring is necessarily required, as long as the client is aware of what happens at the end of the term, and as long as needs have not shifted and health hasn't changed. Typically, whole life coverage is similarly relatively straightforward, although the common presence of dividends, and the fact that policies often take on loans that can become problematic over time, demands some greater attention.

On the other hand, ongoing monitoring is far more important for universal life, and especially variable universal life, because of the extensive non-guaranteed aspects of such policies. Uncertain returns, added on top of costs that are not guaranteed which can and do change, and illustrations that are sometimes opaque, creates a higher burden for ongoing due diligence and a strategy to handle unanticipated problems that may arise with such policies.

Notwithstanding the limitations of basic policy projections for universal and variable universal life contracts, though, monitoring can still be effective. For instance, while many in-force software illustration programs cannot fully model the impact of volatility, the reality is that many such policies are so "unhealthy" that even a standard projection at current rates may reveal that the policy is destined for lapse. In other situations, simply re-running another projection at a slightly lower rate of return similarly reveals that the policy may be at significant risk for lapse. The earlier potential problems are identified, the more time the client has to increase funding to the policy to reduce the amount at risk and increase the cash value base on which future growth can accrue, reducing the risk of lapse.

On the other hand, the "reward" for effective monitoring and good decisions about UL and VUL policies is the opportunity to acquire life insurance coverage - for life - at a more favorable cost, and/or with the opportunity for generating higher cast values, than a whole life policy with a comparable death benefit. Thus, while the complexities of these policy types do present challenges, effective use also presents opportunities.

Hopefully, though, the "questions to ask" and "next steps" information in this newsletter will help to provide a little more structure and guidance in how to evaluate existing life insurance policies, and the action steps that can be taken in response. Alternatively, some planners may wish to reach out to third party insurance analysts (see sidebar on page 5) to either outsource insurance reviews, or subscribe to pricing and performance research services for life insurance (e.g., www.TheInsuranceAdvisor.com) to further support their own financial planning process in this area.

But the bottom line is that ensuring a client does not unwittingly outlive his/her life insurance (and insurance needs) means not just the right decision about a life insurance up front, but an active review process to ensure the right coverage remains in place throughout and that the policy is at least as healthy as its insured.