Fundamentals of Universal Life Insurance

Since its introduction in 1979, universal life insurance has achieved phenomenal sales success. The success of universal life can be attributed to the product's flexibility. Indeed, universal life can be used for virtually every life insurance sale. What's more, if the needs of a policyowner change, a universal life policy can be altered to meet his or her changing needs.

Universal life remains one of the most innovative products offered by insurers and is an excellent tool for financial planning.

Financial advisors are increasingly becoming aware that universal life, because of its flexibility and tax advantages also has some special relevance as a tool for retirement planning.

# Universal Life Insurance— Brief History

Not since the introduction of the "family plan" policy in the late '50s has a life insurance product made such an impact on both the industry and the buying public. Since its debut in 1979, universal life has been an integral part of insurance protection. It has proved to be an effective product, responsive to the needs and demands of a sophisticated market.

Universal life, adjustable life and variable universal life insurance represent three unique forms of coverage distinguished by flexibility allowed in the timing and amount of premium payments, and in the case of variable products the use of a "separate account" of common stocks and investments that policyowners choose themselves.

The design of these policies brought forth the question whether they should be eligible for favorable life insurance tax treatment. This favorable tax treatment would mean that income earned on the cash surrender value of a contract is not taxed until there is a withdrawal in excess of basis or the contract is surrendered for a gain. Also, gross income generally would not include amounts received by a life insurance contract beneficiary if the amounts are paid because of the death of the insured. Prior to 1984, there was no statutory definition of "life insurance."

With the Tax Equity and Fiscal Responsibility Act of 1982, Congress enacted temporary guidelines for determining whether flexible-premium life insurance contracts like universal life or adjustable life qualified as insurance contracts for purposes of excluding death benefits from income. A violation of the guidelines at any time during the life of a contract defined that contract as a combination of term life insurance and an annuity or a deposit fund

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(depending on the terms of the contract). When policyowners died, only the term life insurance components were excluded from gross income.

The Tax Reform Act of 1984 (TRA '84) adopted a definition of a "life insurance contract" as any contract which is a life insurance contract under the applicable state or foreign law, but only if the contract meets either of two guidelines: (1) a cash value accumulation test; or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement. Whichever test is chosen, that test must be met for the entire life of the contract in order for the contract to be treated as life insurance for tax purposes. [ IRC, § 7702 and amending § 226(c) of TEFRA]

If a contract fails to meet either of the alternative tests, the contract will be treated as a combination of term life insurance and a currently taxable fund. This change generally affects policies issued after 1984.

# What is Universal Life?

There are three simple steps to understanding the basics of universal life:

1. A policyowner selects an insurance amount and a death benefit option. There are two death benefit options available with universal life: (a) an increasing death benefit (the sum of the level insurance amount and the increasing cash value), and (b) a level death benefit. Typically, policyowners can change options at any time.

2. A policyowner pays the initial premium. The insurer deducts from this amount an expense charge; the balance of which is deposited into the policy's cash value account where it earns a current rate of return.\*

3. Each month, a charge for the cost of pure insurance (term) protection is deducted from the cash value account. As long as the account is sufficient to support these monthly charges, the insurance remains in force and no premium payments are required. Policyowners may increase, decrease or even skip premium payments, provided their accounts are sufficient.

On a regular basis (annually, semiannually, or quarterly), the policyowner receives a statement from the insurer, outlining the premiums paid, expenses charged, interest credited, insurance costs deducted and cash values accumulated.

Universal life policyowners can also access their cash values (without incurring interest charges or fully surrendering the policy) through policy withdrawals.

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At the inception of universal life, market interest rates were at about the 10 - 11 percent level, and the significant interest rate movements that have come to pass in subsequent business cycles has definitely affected sales and service of universal life contracts.

Individuals who purchased universal life products in the 80s at a time of high interest rates were often given overly optimistic earnings projections. Rosy pictures of so-called "vanishing premium" contracts which were to be "paid up" in a few years did not materialize and policy owners have had to put more money into their policies in order to maintain the coverage.

Also, most universal life contracts offer the opportunity to increase the death benefit, increase the cash value, or decrease the premium. Few of these advantages are available with traditional whole life policies. Universal life contracts generally have lower mortality charges than traditional policies, which is one reason that a younger clientele with limited funds may find that this type of policy provides more flexibility than the traditional whole life plan.

No Lapse Guarantee Universal Life

The hallmark of no lapse guarantee universal life ( a.k.a Universal Life with a Secondary Guarantee) is low cost permanent death benefit guarantees and low cash value accumulations. The death benefits are designed to provide high internal rates of return at all ages of the insured (even beyond life expectancy). The product is designed to provide policy owners a guarantee of life insurance coverage, if all contractual conditions are met, even if the policy's net cash value falls to zero. Thus this policy type has become popular among affluent families seeking tax efficient inter-generational death time transfers of wealth, typically through an irrevocable life insurance trust.

The main advantage of this policy type is low premium rates for death benefits that are guaranteed, independent of investment performance or mortality experience. The main disadvantages of this policy type are low cash value accumulations and policy inflexibility. Policy inflexibility is underscored by the fact that in certain policy forms, premiums must be paid no later than the due date in order to preserve policy guarantees. Depending on contract specifics, policy loans may also cause the policy to lose its original guarantee.

# Universal Life Concepts

The universal life contract is relatively simple. Insured's pay premiums as they would with any other life insurance policy. These premiums can be paid by check, cash, pre-

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authorized check, salary savings deduction or other approved methods. The unique feature is that the amount and frequency of premium payments can be determined by the insured, with a few restrictions.

Policyowners choose an amount of insurance, referred to as the "specified amount," and elect Option A or Option B. (Some policies refer to the plans as “Option One” and “Option Two.”) The specified amount is the amount of life insurance selected by the policyowner, which may include or be added to the cash value. The specified amount for Option A is paid when a policyowner dies, while Option B pays the cash value in addition to the specified amount.

Since the universal life contract is intended to be a life insurance policy, a certain minimum amount of insurance needs to be provided. Without a minimum, the cash value of an Option A contract could easily exceed the specified amount at later policy dates and the contract would cease to meet the Internal revenue Code statutory definition of life insurance [IRC § 7702].

Insurance companies typically account for universal life policies on a monthly basis in the following manner:

1. The fund, or cash value, from the prior month is accumulated with interest for one month.

2. Premiums paid during the month less premium related loadings are added (sometimes interest is allowed on these net premiums).

3. Any other load expenses are deducted (normally only in the first year).

4. The cost of insurance is deducted based on the actual amount of pure insurance risk during the month using a set of monthly term insurance rates.

5. Any withdrawals and related charges are deducted, and interest adjustments are made.

One of the restrictions on premium flexibility is that the policy will terminate if the fund becomes negative. The insured must, therefore, pay enough in premiums to maintain a positive fund. Other restrictions on premium payments are generally implemented for administrative reasons, such as to prevent small irregular payments. Insureds can withdraw all or a part of a policy's cash value. The company may charge a surrender fee for partial or full surrender. Policyowners can borrow against the cash value of universal life policies as they can with a traditional policy; however, the portion of cash value borrowed normally is credited with a lower interest rate than is credited to the amount which is not borrowed.

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The interest credited to the fund is composed of the guaranteed rate and the excess interest rate. The excess interest rate does not always apply to the first $1,000 or so of cash value. The monthly term rate used to calculate the cost of insurance is similar to the rate that might be used for an annual renewable term policy. The rate varies by age and sex and may vary by amount of insurance and smoking habits. Typically, the monthly term rates, known as mortality charges, can be changed by the company (i.e., they are not guaranteed) but cannot be increased above a specified maximum (i.e., the guaranteed mortality charges.

Policy loads generally consist of the following:

1. a percentage of the premium

2. a flat amount per month

3. an amount per $1,000 of specified amount.

In "front-end" loaded contracts the loading cost will be greater in the first year.

The insured may change the specified amount, though such a change is subject to minimums and underwriting requirements established by the insurance company. Policyowners may switch between option A and option B, with such changes subject to underwriting requirements if the amount at risk would be increased. The "amount at risk" is the total death benefit less the fund or cash value.

The riders providing supplementary benefits normally sold in conjunction with traditional life insurance policies can be added to universal life. Many of these riders which have traditionally involved level premiums are priced on the annually renewable term basis when attached to universal life. For disability waiver of premium benefits, the use of annual renewable term rates is further complicated because the premium for universal life is not fixed and the waivable premium is unknown. The most common benefit is a waiver of the term cost, based on the amount at risk. Where the benefit is waiver of the planned periodic premium regardless of the actual premiums paid, the waiver benefit resembles a disability income benefit. Guaranteed insurability riders can be added for scheduled increases in the Specified Amount without evidence of insurability.

Guaranteed Interest and Excess Interest

The cash value of a universal life policy is generated by the premiums after the appropriate deductions have been made for term insurance costs, expense charges, loadings and withdrawals. This cash value accumulates with two kinds of interest:

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guaranteed and excess (i.e., non-guaranteed interest).  To maintain competitiveness in the savings and investment market, companies also credit excess interest on the cash value of universal life policies. Excess interest can be credited in several ways, and companies must choose the right one for their unique circumstances, taking into account marketing techniques and investment strategies (both long and short rm). Companies must select interest rates that will lead to a desired profit margin while keeping products competitive.

A company's investment strategy is an important factor for determining the amount of interest to be credited. Effective investment strategies should produce enough income to pay a competitive rate of excess interest and leave the company with a suitable profit margin.

The crediting of excess interest is one of the major advantages of universal life products and an obvious attraction for the consumer. It allows the company to pay competitive rates without the dangers inherent in long-term guarantees. But, as has been demonstrated, the amount and type of excess interest must be based on marketing strategies, investment policies and company objectives.

Cost of the Insurance Element in Universal Life

The basic insurance benefit provided by universal life is term protection for the net amount at risk. Just as the guaranteed interest represents the minimum amount that the policyowner will earn on the cash value of the policy, the guaranteed insurance cost represents the maximum charge for the term coverage. The cost of insurance is normally lower than the guaranteed rate. The use of a variable cost of insurance has the same effect as the flexible interest method: it allows the company to offer competitive rates without incurring deficiency reserves and allows them to revise rates to reflect future mortality levels.

The Expense Element in Universal Life

The loads and surrender charges in universal life policies, in combination with the margins of interest credited and term costs charged, must cover the agent's compensation, the company's expenses, and provide the profit margin. Generally, the load charges and other margins in universal life more closely match the various expense elements than traditional life insurance product fees match their expenses. This is desirable for both the companies and buyers, because persistence is less important, and persisting policyowners do not need to subsidize policyowners who terminate early.

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Loading Methods

Loadings can be expressed in many ways. They can be related to premiums, the investment portion of the policy or the insurance portion of the policy, or they may take the form of surrender charges. The simplest form is a monthly charge per policy. A mixture of loading methods is generally employed in order to maintain equity between large and small policies and between insurance-oriented and investment-oriented policies.

Load fees may be related to the premium in a number of ways. For one, a load charge may take the form of a percentage of the premium.

A graded approach can also be used, charging, for example, 15 percent of the first $1,000 of premium and 7.5 percent of any subsequent premiums.

A loading charge method that gives even more recognition to the economies of scale is the per-policy charge.

Loads can also be applied directly to the insurance portion of the policy. For front-end loaded policies the most common is a charge per $1,000 of the specified amount, charged in the first policy year only.

The insurance portion of the policy can also be used to develop "hidden loads." Banded rates which charge more for the first $10,000 at risk generate the equivalent of an annual policy fee. Similarly, the use of aggregate cost of insurance rates rather than select and ultimate rates generates additional margins in the early years of a policy which can be used to offset acquisition expenses.

A common method of providing for maintenance expenses is the so-called hidden load method, which occurs when excess interest is not paid for the first $1,000 of a policy's cash value.

Surrender Charges

Surrender charges constitute another form of load. It is common to charge the balance of any non-level first-year loads that have not been deducted, if the policy is surrendered in the first year. After the first year, surrender charges may grade down over time and constitute what is referred to as a back-end load. The back-end load can be used to cover initial expenses where the policy is not held long enough for the company to recover these initial expenses from renewal margins. There may also be an excess interest penalty upon withdrawal which is designed to cover the cost of

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processing the surrender. Direct sequestration of this withdrawal charge is a violation of non-forfeiture laws.

The partial surrender of a universal life policy is generally available at any time and is usually subject to a surrender charge. The frequency of partial surrenders may be limited. In some cases, surrender charges may not apply to an initial percentage of the cash value surrendered each year. In the event of partial surrender, the death benefit will be reduced by the amount withdrawn.

Summary

Loads and expense charges constitute an important element in determining the cost efficiency of universal life policies. Often their impact is difficult to determine because of the many ways in which they are assessed. Certain hidden load charges, such as the excess interest exclusion may not be apparent to the buyer, especially at the time of sale.

The trend has been toward direct loading fees that do not cover all expenses and commissions incurred by the company. This necessitates the recovery of the difference between these expenses and the profit element from hidden loads, margins in the interest rate credited, the internal term premiums charged and renewal loadings.

# Comparative Structural Analysis of Universal Life, Interest-Sensitive Life and Participating Whole Life Product

In recent years, the three permanent products— universal life, interest-sensitive life, and participating whole life— have occupied center stage in the marketplace of non-variable life insurance. While each product has its supporters and detractors, it would be more equitable to say that, according to client needs and suitability, each type of contract has its useful niche. Too often, however, agents sell one or the other on a "best buy" basis, according to some particular illustration of policy rates and values. This approach, which generally glosses over the unique policy structure of each product, does not necessarily ensure that the client has received the best policy for his or her individual needs. Policy results also will vary according to the methods by which insurers calculate premiums and cash values and the manner in which profits are derived. The knowledgeable financial planner will take these factors into consideration. With the variety of contracts available today, each type of permanent product can be selected to match an individual client's predilection as to requirements such as flexibility and the degree of customer preference for risk acceptance.

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Structural Differences

The components of all three types of policies basically involve three factors: (1) mortality charges, (2) expenses, and (3) interest rate credits. These factors are applied differently in the contrasting types of products, as follows:

Conventional participating ordinary life contracts involve the calculation of mortality and expense charges plus an assumption of interest earnings. Death benefits and cash values are guaranteed, and profits resulting are distributed among the policyholders as dividends.

Interest-Sensitive Whole Life

Mortality and expense charges in these contracts are calculated and a choice of premiums may be offered to the buyer, based on either a conservative guaranteed or higher projected interest rate. The actual amount of cash value in the policy will depend on the interest rate actually credited. Interest may be credited annually or more frequently. The interest rate may reflect earnings of the company's entire portfolio, with an allowance for profit.

Universal Life

This innovation separates the investment portion from the death benefit side. Mortality, expense and a basic interest rate calculation are factored in for the generation of a premium estimate. Premiums may vary after the initial deposit, at the option of the buyer, depending on values and earnings of the contract. The actual premium goes into a fund, expenses are debited, and the balance earns interest declared by the carrier. A guaranteed premium can be offered, based on a low guaranteed interest rate. Mortality rates may also be guaranteed, or the carrier can include in the mortality rate a charge high enough to cover profits and expense factors. However, many universal life marketers count on profits being earned from the investment spread, i.e., the difference between the interest rate declared to the policyholder and that earned by company investments.

Pricing Factors in Policy Comparisons

Among factors to be considered by the planner in placing a client with a certain company will be the manner in which interest is calculated. For example, to what policies are interest rates applied and how often are they changed? In examination of participating polices, the agent will want to know how often dividend scales are changed.

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In an ideal match, the planner will fit the particular system to the client's needs and desires. Those customers who want current new money rates would look for a different company than a buyer who would desire a rate blended over a long period of time. A product with volatile interest rates might suit some clients, but not others. As to rule-of-thumb benchmarks for matching a product to a customer, it might be recognized that with universal life, the client takes the risk. If the assumed interest rate drops because there is not a lot of leeway in the calculation of premium, additional money will need to be deposited; therefore, this contract may not be suited to the conservative client. This client will probably be a better candidate for a participating policy that embodies basic guarantees. Other clients will accept some risk but like the idea of a guaranteed premium. Interest sensitive life may be the answer for such individuals.

Company Rate Calculations

In the process of making comparisons between products, it is important to be aware of how the company has calculated profit margins. Simply comparing interest rate to interest rate, without being aware of this factor, may be a misleading approach. One company may take its profit from the interest spread, i.e., the difference between the rate offered the customer and the rate earned on investments. Another carrier may depend on the excess charges for expenses and build in its profit margin accordingly. Where interest rate projections are made, two major variables come into play, affected by the carrier's decision to determine whether business is going to be blocked and matched with interest returns or whether the company's interest return is going to be attributed to the entire portfolio. If the purchase of a policy takes place when interest rates are high, it may be matched to investments made at that time, and dollars might thus be identified with that return throughout the life of the investments. New money would be accorded corresponding new interest rates. If the company uses a total portfolio approach, all of the investments are put together in a blended rate, regardless of when an individual policy was purchased. The resulting interest earning is posted to all policies and all money received during the year. The difference in approach may hold true for both universal and interest-sensitive contracts where interest rates are clearly identified and will affect participating policies in determination of the actual dividend scales.

Differences in company policy will affect the decisions made concerning declarations of interest rates. Some companies feel that it is a more equitable arrangement to match

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blocks of investments with policy values so as to more accurately reflect a changing market. Others feel that a blended rate will offer more stability over a longer period of time and that frequent changes in interest rates may cause customer concern that at some time more money will have to be put into the contract. Occasionally, a company with this philosophy will even support a rate to keep it at a promised level in order to counteract a temporary downturn in investment results. There are companies that offer customers a choice as to which type of investment rate they would like applied to their policies. These may be identified as a "portfolio rate policy" or a "declared interest rate" contract.

Comparing the Three Products

Universal life is the most flexible of the three types of contracts. Decisions can be made during the life of the contract about varying premium payments. Withdrawals can be accomplished without policy loans and the amount of death benefit may be changed. Such options vary according to policy contracts. Universal life may provide the opportunity for the lowest premium because the rate is based on current earnings assumptions. The agent can thus, optimistically, assume the lowest mortality and the highest interest rate, although the client should be aware that some risk is involved in adopting such assumptions. The initial death benefit in a universal policy will remain at the amount of inception as long as there is enough cash value to support it.

Interest-sensitive life has premium flexibility insofar as allowing the client to set a premium amount and payment period when the contract is initially purchased. In this type of product, the guaranteed death benefit decreases after some period of time, based on guaranteed interest and mortality, although the projected death benefit stays level. Universal life has not fared well in the last few years in public perception, mostly due to falling interest rates. Agents who sold the product at unrealistically low premiums have been faced with the prospect of going back to clients and informing them of the need to deposit more money. Many clients had purchased universal life contracts at much lower premiums than comparable whole life contracts. When interest earnings dropped, customers realized that rates had not been guaranteed. The guaranteed rates were reasonably favorable and they were basically the same rates that were offered before. The problem has been that the higher projections were simply not borne out by actual performance, a common occurrence when speculating as to future investment returns. However, traditional buyers of insurance are not always accustomed to the vagaries of investment returns.

In summary, the client will probably expect the conscientious planner to do some necessary spadework on behalf of his customer. With all contract varieties in the

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marketplace, the planner is expected to choose a policy structure that is suited to the client. The next step is for the agent to investigate the company, asking such questions as: What does the company management do with its money? Will the investment practices of the potential carrier match the desires of the client? Admittedly, this approach requires more perseverance on behalf of the client than simply picking a desired product, running illustrations, and then attempting to sell what the planner wants to sell. In some cases, the planner will try to steer a client to a higher premium contract, but one that has firm guarantees. Unfortunately, a competitor may operate without such consideration for the customer and may offer a lower premium with some unverifiable promises about higher projected interest rates. Perhaps the answer is simply for the responsible planner to be as conscientious as possible, be truthful, and hope that, in the end, the consumer and the financial services industry will have benefited by this professional approach.

# Use of Individual Universal Life in Retirement Planning

Financial planners are increasingly becoming aware that universal life, because of its flexibility and tax advantages also has some special relevance as a tool for retirement planning.

# Taxation of the Policyowner

The federal income tax benefits afforded flexible premium life insurance contracts are a major advantage of universal and variable universal life insurance products.

# The Commission Structure of Universal Life

There are two basic approaches to sales compensation on universal life— the component and the target premium approach.

Component Approach

The concept underlying this method is that each element of the universal life contract should be compensated appropriately. The normal elements are:

1. the premium;

2. the specified amount; and

3. the policy.

For example, a company could pay the following as first-year compensation:

1. 6 percent of the first-year premium;

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2. $0.167 per month per $1,000 of Specified Amount; and

3. $20 per month.

A $100,000 whole life product issued at age 35 with a $695 premium will provide total sales commission of $482 ($42 + $200 + $240), which is 69 percent of the first-year premium.

If the insured chose to pay $1,500 annually, the commission would be 35 percent. If he or she chooses to pay less than $695, the commission would increase as a percentage of the premium; however, the minimum premium in the first year for a policy with this structure would be near the $695 figure. The savings element would be commissioned at a marginal rate of only 6 percent, whereas the insurance element is commissioned at a much higher rate. Agents also receive a flat amount per policy to compensate for the effort related to the sales. This amount is not related to the size or type of policy.Renewal commissions and service fees are generally based on a percentage of premium paid. The commissions on increases are discussed under a separate topic.

This otherwise simple structure is often complicated by the following:

1. the payment of a commission on the internal term cost;

2. the reduction of premium commission percentages on amounts in excess of an imposed limit, which is related to the total premium paid in the first year;

3. the payment, as a commission, is a percentage of the excess interest credited to the policy;

4. the payment, as a commission, is a percentage of the fund; or

5. a variance in the per $1,000 commission by issue age.

When the component method is employed, a policy's loading fees tend to follow the sales commissions.

Target Premium Approach

This approach attempts to divide the sales compensation into compensation on (1) the basic "whole life equivalent" and (2) any additional savings element.

For commissions purposes, a "target premium" is usually the level premium necessary to develop the equivalent of a traditional whole life policy, using a conservative assumption to project universal life policy's cash value.

The target premium might also be defined as the level premium necessary to:

1. provide a level death benefit equal to the initial Specified Amount;

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2. provide a cash value at age 95 or 100 equal to the Specified Amount or one sufficient to guarantee a benefit equal to the Specified Amount at death; and

3. support an assumed level interest rate of 8 percent to 10 percent.

These target premiums may also be defined as an amount per $1,000 of Specified Amount or as a unique amount for each Specified Amount.

Premiums in excess of the target premium are commissioned at a low rate, usually at the renewal level of two to five percent. Because the premium is paid and interest credited, term costs actually assessed and partial funds withdrawn will alter the buildup of the cash value. The target premium is theoretical only and is usually used solely to determine commissions. However, in some cases, the target premium is used to determine the first-year load charge. Policies may guarantee not to lapse for a predetermined number of years if the target premium is paid.

When using the target premium approach, the first-year commission or levelized commission is expressed as percentage of the target premium plus a "renewal like" commission (two to five percent) on any premium paid in excess of the target premium.