Managing Life Insurance in a Trust Setting - Understanding the Actual Policy

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Understanding The Actual Policy

Term → Whole Life → Current Assumption Universal Life → Secondary Guarantee Universal Life → Variable Universal Life → Index Universal Life

Term Insurance

- Easiest life insurance to understand. You pay a premium for a death benefit only.
- Level Term insurance coverage is coverage for a specific period (up to 30 years) for a level premium, which is usually guaranteed, after which the coverage is often dropped. These level Term policies can often be continued, usually after a re-insurance process, called re-entry. At re-entry the insured must submit to another underwriting process. The cost of the continued coverage for the additional time period will increase because of the increased age of the insured. If the health of the insured has deteriorated, it may dramatically increase.

Term insurance policies often contain a Conversion provision that allows the insured the option to convert the Term policy to a Permanent policy at current age and insurance rates, without providing evidence of insurability.

- Term insurance policies often contain a Conversion provision. This allows the insured the option to convert the Term policy to a Permanent policy at current age and insurance rates, without providing evidence of insurability. This is a very important provision, especially if the policyholder has suffered a change in health.
- Term insurance is typically used for short term coverage. Often it is used for those who have a large insurance need but lack the cash flow currently and will convert the coverage to Permanent coverage in the future.

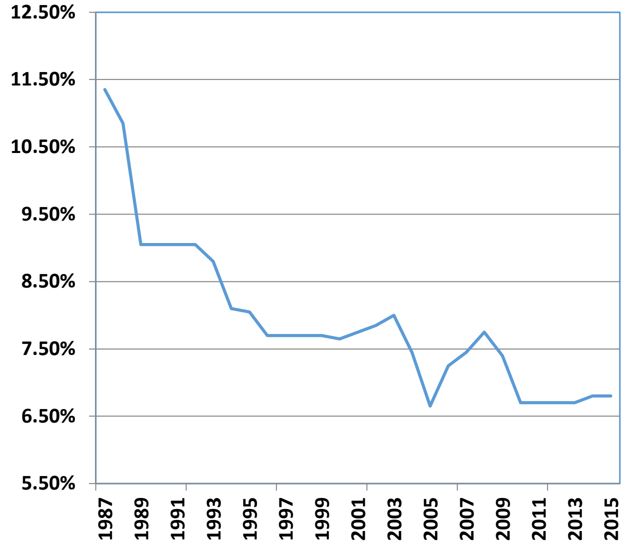
Whole Life Insurance

- A Whole Life policy provides a guaranteed death benefit as long as premiums are paid, as well as a guaranteed cash value. Most Whole Life policies also provide for additional cash value through dividends.
- The investment portion of a Whole Life policy goes into the General Account of the life insurance company composed primarily of long term bonds and mortgages, as dictated by various state insurance laws.
- Whole Life contracts pay dividends considered to be a return of premium paid when premiums received turn out to be more than the company needs, because fewer insureds die, expenses are lower, or portfolio returns are more than expected. Dividends can fluctuate above and below the dividends shown in the current illustration.
- The dividends that are earned on a policy can be used in a number of ways:
    - To reduce premium
    - Taken in cash
    - Purchase "paid up additions"
    - Left with carrier at interest
    - Repay loans on the policy

Bonds	71.50%
Mortgages	11.90%
Policy Loans	4.00%
Cash & Short Term Investments	3.20%
Stocks	3.70%
Real Estate	0.70%
Other Invested Assets	5.00%

Average General Account Portfolio of the 25 largest insurance carriers.

- Whole Life contracts can be blended with a Term portion, typically through the use of a Term Rider. This lowers the cost of the policy, but also lowers the guarantees in the policy as the cost of the Term portion is not guaranteed. Typically these plans are designed so that over time the Term portion is replaced with paid up base Whole Life coverage, until the entire contract has been converted. The ability to convert the policy is driven by premium paid and dividend performance and the amount of Term coverage that is to be converted. In some situations where there is a high Term component it is often impossible to convert all of the coverage over and the policy death benefit in the later years will drop, or the cost to maintain death benefit will increase.



Whole Life Dividend Rates for Major WL Carrier

Insurance companies provide a sales illustration which shows how a policy might perform under various conditions and with different dividend options. With a Whole Life policy the illustration will show guaranteed cash value as well as the cash value growth attributed to dividends. **The illustrations usually show the outcome based on current dividends which may or may not occur.** It is important to understand that Whole Life policies will perform differently with different dividend assumptions.

- Although Whole Life policies have fixed premiums, premium does not always have to be paid out of pocket. As mentioned, dividends can pay the premium or even a portion of the premium. The premium can also be paid from the cash value of "paid up additions", those little paid up policies within the contract that are purchased with dividends. If the dividend or other sources are not enough to pay the policy premium, the premium can be paid by a policy loan. Often, this occurs automatically – a feature know as Automatic Premium Loan (APL).

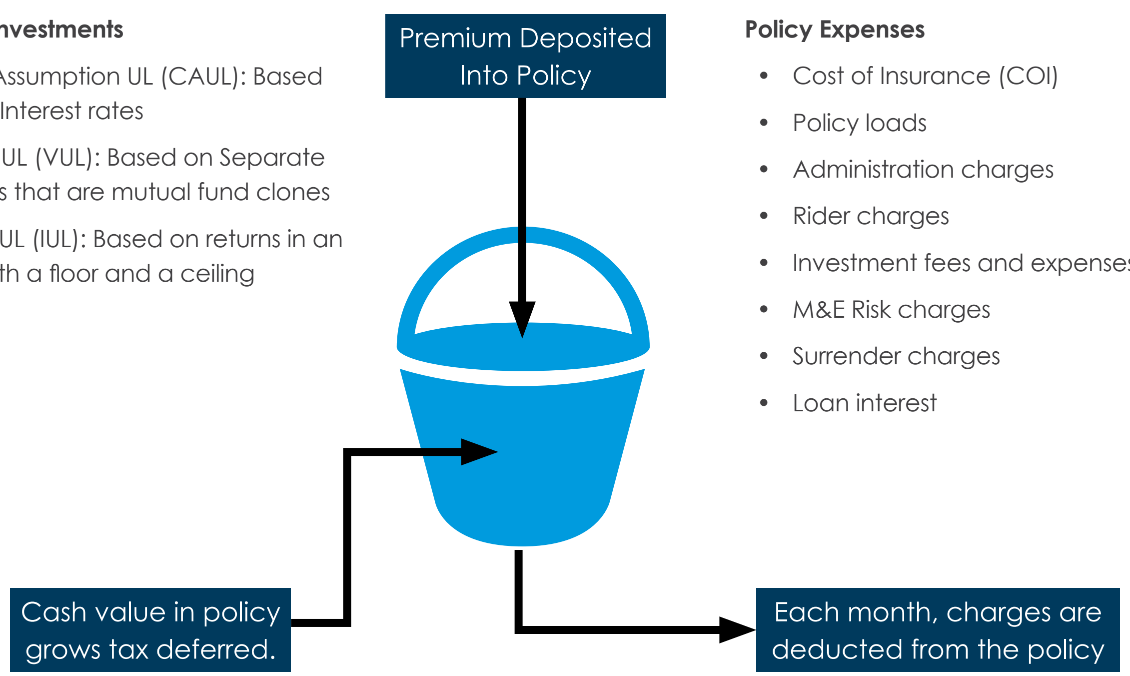
Universal Life "Chassis"

Cash Value Investments

- Current Assumption UL (CAUL): Based on Fixed Interest rates
- Variable UL (VUL): Based on Separate Accounts that are mutual fund clones
- Indexed UL (IUL): Based on returns in an Index, with a floor and a ceiling

Policy Expenses

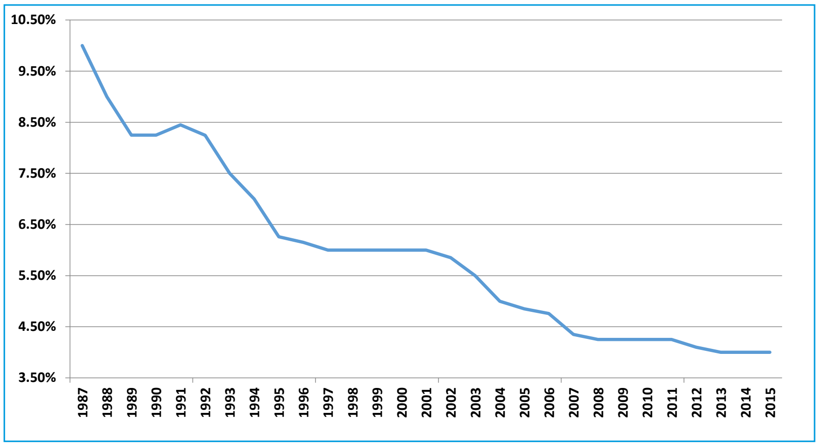
- Cost of Insurance (COI)
- Policy loads
- Administration charges
- Rider charges
- Investment fees and expenses
- M&E Risk charges
- Surrender charges
- Loan interest



(Current Assumption) Universal Life (UL) Insurance

- During the late 1970's and early 1980's, short term interest rates skyrocketed. The public clamored for an opportunity to participate in this high rate of return, and Money Market funds were born. Money flowed out of existing Whole Life policies into these newly formed Money Market funds.
- The insurance industry, being market driven, came up with a product that would combine the high rates of return existing in that day with the tax advantages of life insurance.
- For the first time there was total transparency in a life insurance product.

From 1981 to 1986, the percentage of Whole Life policies sold dropped from 78% of the marketplace to 30%, as the sale of Universal Life policies grew.



- A Universal Life policy allows adjustment of both the face amount of the policy and the premium level funding the policy - subject to minimum funding levels to start the policy. Underwriting approval is needed if death benefit is raised. Universal polices stay in force as long as the cash value in the policy is adequate to cover the expenses in the policy.
- When first introduced, all of the policies sold were sold based on projected current assumptions – the interest rate being paid at that point in time and the current costs being charged on the policy. The current crediting rate over the last 28 years for a top tier Universal Life carrier is shown above. Rates have fallen over the years. If policy performance expectation during policy lifetime was based on current crediting rate at time of sale, the policy cash value would not have earned nearly what was expected. Most of the policies sold in the last twenty eight years, if sold with a premium expectation based on these current assumption projections, turned out to be underfunded and many lapsed or will lapse without additional funding.

Because so many Current Assumption Universal Life policies were underfunded and many lapsed, the insurance industry came up with a new feature in Universal Life polices – the Secondary Death Benefit Guarantee.

(Secondary Death Benefit Guarantee) Universal Life Insurance (GUL)

- A new generation of Universal Life policies with death benefit guarantees took the market risk out of Universal Life policies; however it took the premium flexibility that was an advantage away.
- With a guaranteed death benefit policy you have a stated premium that must be paid in full and on time or the policy death benefit guarantee will be compromised – typically lowering the age to which the policy is guaranteed. Each carrier has different policy designs but in most situations if a premium is missed or late, a "catch up" premium can be paid to put the policy guarantees back on track. However, these policies should not be thought of as flexible premium and if purchased should be purchased with the understanding that a fixed premium will be paid each and every year.
- One disadvantage of these newer generation policies is that the cash value growth is typically much less than with a Current Assumption product. The product is designed to provide a guaranteed death benefit, not develop significant cash value. If you look at a sales illustration of one of these policies you will see that the cash value will often go to zero at some point. At this point the policy is running on the death benefit guarantees, not the cash value, which has been exhausted.
- Changes to the reserve requirements for GUL policies occurred in the beginning of 2013. The cost of GUL policies increased or the policy death benefits were shortened.

Variable Universal Life Insurance

- Introduced in 1985 by Pruco Life, a subsidiary of Prudential Life.
- Like Universal Life, had a flexible premium.
- The most important difference was that the owner of the policy, not the carrier, invested the cash value.
- Cash value is invested in Separate Accounts that are mutual fund clones.
- Like Universal Life, the VUL policy will stay in force, for as long as the cash value in the separate accounts will pay all policy costs. But unlike the Universal Life policy, a VUL policy investment could actually lose money, making the product more unpredictable.
- Variable Universal Life policies have been used as investment vehicles.
- When funded to reach a certain goal the investment return will have a large impact on the premium needed. The chart to the right shows the annual premium needed to run a VUL policy to age 110, assuming a 65 year old Male underwritten as a Standard Non-Smoker.
- All VUL policies have a Fixed Account option that allows for a guaranteed rate of return.

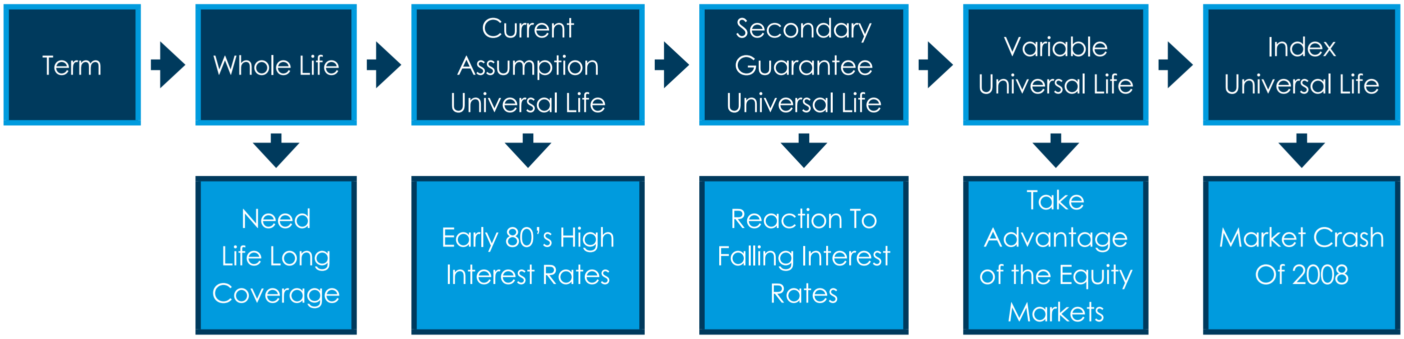
	Run to age 110
4% Net	$34,727
6% Net	$30,811
8% Net	$27,750

Indexed Universal Life Insurance

- Designed to provide "upside" of equities while limiting losses.
- The product ties investment returns to a specific index such as the S&P 500® Index. It eliminates down years with losses by providing a floor to the investment return. This floor might be as low 0% but will never be a negative return.
- In addition, there is a participation rate, a percentage factor that the actual index return is multiplied by to arrive at the adjusted return. The chart below shows the credited rate outcome for a sample policy with a 100% participation rate and a growth cap of 10% and floor of 0% at various actual index rates.

Actual Index Rate	Times the Participation Rate	Equals the Adjusted Growth Rate	Subject to Growth Cap of 10% and Floor of 0%	Equals Credited Rate
18%	100%	18%	Subject to Cap	10%
9.25%	100%	9.25%	No Cap/Floor	9.25%
-14.25%	100%	-14.25%	Subject to Floor	0%

Life Insurance Time Line Recap



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