

Understanding Universal Life Insurance

Universal life insurance has been around for over two decades. Original proponents hailed it as the most revolutionary concept in the insurance industry. Critics have decried it as the worst thing ever to happen to the insurance-buying public. Universal life insurance is at neither extreme. It is merely an insurance product option, more suitable to some situations than others. Universal life is not the only advisable type of coverage to own. However, the product is extremely flexible. This very flexibility may be the source of much confusion among producers and consumers. The purpose of this white paper is to offer a thorough explanation of universal life insurance, so that our clients may make informed decisions in the addition of insurance to their portfolios.

Product Background

Please refer to the chart titled “Anatomy of a Flexible Premium Life Insurance Policy” at the end of this white paper. This chart is a simple visual model of a universal life insurance policy - a bucket with a spigot. Here's how the bucket works:

The premium payer (usually the policyowner) pays a premium. This premium may be any amount desired, from the minimum set by the insurance company to the maximum amounts permitted by Federal income tax regulations, and may occur anytime during a policy year. Hence the “flexible premium” designation.

The net premium is the premium paid less any applicable premium load. This incoming net premium creates or is added to the policy's accumulated cash value account, hereinafter called simply the cash value.

The gross death benefit is the full bucket. The difference between the gross death benefit and the cash value is the net amount at risk. The net amount at risk is also known as “pure” insurance, since from the insurance company's view, it is the coverage that exceeds the assets represented by the policy's cash value.

The net amount at risk is what determines the mortality charges, discussed below.

Each month, the carrier adds interest credits to the cash value. The amount of the interest credit is based on:

- The amount of cash value, and
- The current interest-crediting rate.

There is a guaranteed minimum crediting rate. Current crediting rates are generally in excess of this minimum. The current rate will reflect recent carrier investment experience, which in turn is affected by prevailing interest rates. This fluctuation in crediting rates gives rise to the term “interest sensitive,” which is often applied to universal life policies.

The insurance company deducts certain items from the cash value:

- **Policyowner Cash Withdrawals.**
Withdrawals are deducted from the cash value along with any surrender charges that may be levied. Surrender charges generally apply only in the earlier years of the policy.
- **Expenses.**
These are the monthly expense charges as defined in the policy. Insurance company expenses may actually be higher than these explicit expense charges. Expenses in excess of the contractual charges

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are recovered from other areas, such as mortality charges in excess of actual mortality experience and/or spreads between interest yields on the carrier's portfolio and the actual interest credited to the cash value.

– Mortality Charges.

This is the monthly charge that the insurance company deducts for death benefits in excess of the cash value. It is also known as the Cost of Insurance, or COI. Maximum mortality charges are defined in the policy. Current charges are generally substantially below the guaranteed maximum charge. The mortality charge is the product of:

- The net amount at risk at the beginning of the policy month, and
- The applicable current mortality charge for the insured's age, sex and risk classification.

Generally, if the beginning-of-month deductions should exceed the beginning-of-month cash value, the policyowner will have coverage only for a partial month, after which time the policy will lapse unless additional premiums are paid.

In other words: the bucket can run dry. We would not usually want this situation to occur; periodically reviewing policy performance and paying adequate premiums can avoid it.

Some carriers waive all charges (expenses and mortality charges) after a specified attained age, such as age 100.

How Illustrations are Targeted

Since the premium is flexible and policy performance will fluctuate, the inevitable question is: How do I know what the policy will look like in the future? The answer is simple: You can't know exactly how it will look in the future.

Predicting policy performance is similar to the task facing an actuary designing a pension plan: he doesn't know what is going to happen in the future, but he has certain targets that he'd like to see met in terms of benefits to plan participants.

What the actuary must do is define the targets, make assumptions about future performance, and then solve for certain critical variables, such as the required annual funding deposit into the pension trust.

In a similar vein, we set targets for our universal life policy. We call these targets Policy Management Parameters. We cannot specify all of these policy parameters in a given situation. However, we can set some, and solve for the remaining "floating" parameters. Policy Management Parameters include:

– Cash value at a given age.

Common targets include a cash value of zero at a late age, such as 95, or a cash value equal to the initial face amount of insurance at a given age.

– Premium amount.

We can use a desired premium schedule, which may vary over time, and may even include withdrawals ("negative premiums," if you will).

– Premium duration.

The targeted duration may be lifetime premiums, or may be limited to as little as one year. Commonly targeted durations are 10 or 15 years, or to age 65.

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- **Coverage pattern.**

There are two “automatic” coverage patterns typically available:

- **Level coverage.**

If a \$1,000,000 policy is purchased, then that is the gross death benefit for the duration that the policy is illustrated; it is inclusive of the cash value. This is normally referred to “Option A.”

- **Level coverage plus the cash value.**

If a \$1,000,000 policy is purchased, then the death benefit will be the \$1,000,000 plus the current cash value. This is normally referred to as “Option B.”

Some carriers offer other automatic coverage patterns, such as face amount plus the sum of all premiums deposited.

In addition to automatic patterns, universal life coverage may be varied on an ad hoc basis after policy issuance. The policy owner may reduce coverage unilaterally; increases in coverage are subject to evidence of insurability. However, there is a cost for additional death benefits: recall that mortality charges are always levied on the net amount at risk.

In addition to setting the Policy Management Parameters, we must make assumptions about certain internal policy functions. We call these items Policy Performance Parameters, and they include:

- **Mortality charges.**

We can assume that the carrier will in the future charge mortality based on the current table, or we can assume a table that is higher or lower than current. The less mortality we assume, the better the illustrated performance will appear.

- **Interest credits.**

As with mortality charges, we can assume that the carrier will credit interest in the future based on the current rate, or at a different (usually lower) rate. The higher the interest credit assumed, the better the illustration will appear.

- **Expense charges.**

Most carriers do not vary their explicit expense charges; thus, expense charges are not typically a variable parameter. As covered earlier, if a carrier needs to make up additional expenses, the usual method is to increase their spreads on interest credits or mortality charges.

Care must be exercised in setting Policy Performance Parameters. Overly optimistic assumptions will produce unrealistic projections that will probably not be reached. The goal should be to set assumptions for future Policy Performance Parameters at levels that are likely to be attained.

Getting Started

Having seen all the variability in a universal life insurance policy, how does one put structure around the policy design? These are the typical steps:

- Determine the coverage objectives, in terms of amount, pattern, and duration.
- Set tentative values for other Policy Management Parameters, including:

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- Desired cash value at specified age(s),
 - Premium amount,
 - Premium duration, and
 - Cash withdrawals, if any.
- Set Policy Performance Parameters Assumptions.
- Mortality rates. The assumption of improving mortality has to be questioned and in most jurisdictions, cannot be illustrated. Assumed improvement may greatly understate actual future mortality charges, and will thus overstate illustrated policy performance. If a carrier is using improved mortality assumptions (which is not always easy to determine), then the projected values may be of questionable value.

If the carrier is not using improved mortality assumptions, we would normally start an analysis with the current unimproved mortality charges.

- Interest crediting. The key assumption in the policy illustration is typically the crediting rate to be used in the future. In a period of high short-term interest rates, the then-current crediting rate will likely not be maintained for the long run. It is therefore important in times of high interest rates that conservative rate assumptions be used. In most jurisdictions, carrier software cannot illustrate a rate higher than that currently being credited.

Solve for unspecified Policy Management Parameters. If the results are not satisfactory, vary the Policy Management Parameters - or the gross death benefit amount, pattern or duration - until overall functioning of the policy meets your needs.

Variable Universal Life

An adaptation of the universal life approach is the variable universal life policy, in which the net premiums may be invested in one or more portfolios held in separate accounts, rather than in the general assets of the insurance carrier.

There are some important differences between the traditional universal life policy and the variable universal life policy:

- Unlike the owner of a traditional universal life policy, the variable-life policyowner may make investment choices, and bears the investment risk on the portion of premiums allocated to the separate accounts. Note that the policyowner may allocate net premium to one or more portfolios, and may transfer existing accumulated cash values from one portfolio to another.
- Rather than having a monthly addition to the cash value based upon a declared interest-crediting rate, the accumulated cash value of the variable policy is adjusted to reflect the investment experience of the separate accounts selected. The adjustment is done on valuation dates, which are typically defined as each day that the New York Stock Exchange is open for trading and the insurance carrier's administrative offices are open for business.
- In addition to the premium loads, administrative expenses, and costs of insurance found in the

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traditional universal life policy, there are additional fees, which may be applicable, including Mortality and Expense risk charges and investment management fees.

- Setting the Policy Performance Parameters for the variable policy is not unlike the procedure use with the traditional universal life policy. Most carriers' illustration systems will accommodate gross earnings assumptions of 0% to 12% (the SEC-mandated maximum rate which can be used), and many can illustrate based upon historical returns of the separate accounts, or at negative yields. As with the traditional policy, the more optimistic the assumptions, the better the illustration will appear.

Any illustrations produced for a variable policy are purely hypothetical and do not represent the performance of any investment. Actual performance will vary from illustration assumptions, and it is advisable to analyze the variable policy under various investment scenarios.

- The separate accounts have no guaranteed investment yield. Poor performance of the investment subaccounts selected may decrease the policy's cash value and death benefit.
- The variable universal life policy is a registered product, and it is important for the buyer to read the prospectus provided before making a decision to buy the policy.

Policy Administration

Just as the pension actuary periodically checks pension plan performance against prior projections, we must periodically review the policy's actual performance against original projections.

It is a certainty that actual performance will not exactly match the original projections because some or all of the actual historical Policy Parameters (Management or Performance) will no doubt differ from what was originally set or assumed. Additionally, objectives, needs, and resources will all change over time; the policyowner may well have different objectives than when the policy was originally acquired.

For these reasons, we must perform re-illustrations of the policy. That is, given where the policy is at a point in time, and given the new Policy Management Parameters and assumed future Policy Performance Parameters, we must re-solve for the unspecified parameters. By revisiting the performance periodically, we can avoid funding surprises.

Carrier Selection

Projections and illustrations are just that. Regardless of the assumptions that are considered when creating these projections, actual policy results will vary according to the performance of the company that issued the policy. Although performance of a policy or an insurer cannot be guaranteed, there are things that can be done to help mitigate the risk of less-than-desirable results.

- Company size is a good starting point. If we want to place business with the top 10% of companies, as measured by admitted assets, that narrows us down to about 150 companies. As a matter of practice, BBVA Compass Insurance prefers to work with companies ranked in the top 100.

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- Another indicator is the ratings that the carrier has received from various services:
 - A.M. Best Company Rating
 - Moody's Financial Strength Rating
 - Standard & Poor's Financial Strength Rating
 - Fitch Insurer Financial Strength Rating
 - Weiss Safety Rating
- BBVA Compass Insurance is careful to place business only with carriers which qualify as top companies. As brokers, we can represent virtually any major carrier in North America, and are therefore able to represent our clients to a broad marketplace.

Summary

We hope that this overview of universal life and variable universal life insurance has been helpful to you. We at BBVA Compass Insurance pride ourselves on our resources, including personnel, administrative systems, equipment, software and carrier relationships. Our objective is to bring these to bear in providing our clients with the very best in products and services - now and in the future.

Please allow us to be of assistance to you in your business and personal insurance planning.

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