Further Observations on Life Insurance
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I. Low Interest Rates and the Future of Whole Life and Universal Life. As we write in early June 2013, anyone with a bank CD knows how low interest rates have fallen. The 1-year CD rate is about 1.15%; jumbo 5-year CD rates nationally top out at about 1.75%. Shorter term maturities scale down to about 0.25% for a 3-month CD. Interest rates have not been this low since World War II, when they were forced down by the government so that the cost to borrow for war purposes would be minimized. Thirty-year fixed rate mortgages are under 4%; when the writer borrowed for his first home in the late 1950s, the rate was 5%, and that was from his employer, a life insurance company. Where will this lead?

It is worth knowing that Japan has been through a two-decade or longer period of ultra-low interest rates. Indeed, for a short time negative interest rates prevailed; corporations paid the government a fee to keep money safe. From 1997 to 2001 eight Japanese life insurers failed; interest rate guarantees built into whole life policies in the 1980s and early 1990s could not be earned later on. In 2008, another Japanese life insurer failed; evidently, it tried to earn higher returns internationally but the worldwide recession and/or currency changes doomed it.

There is a huge volume of life insurance in force guaranteeing to pay 4% on cash values, sometimes higher; many life insurers are currently living off returns on long-term investments made in the last 20-30 years at higher interest rates. Life insurers for at least 30 years have used Moody's (now Mergent's) Corporate Bond Yield Averages (CBYA) to determine variable policy loan interest rates. The CBYA shows current yields to maturity on newly issued long-term bonds averaged across the four investment grades. It is a good indicator of returns life insurers can safely earn, before the expenses of investment departments, on new investments of their cash flow, which is heavy. In 1982, the CBYA was 16%, which may be hard to believe if you're not an old person like the writer. By mid-1987, the rate was down to 9.8%; then 8.6% in 1992; 7.7%, in 1997; 7.4% in 2002; 6.0% in 2007; and 5.3% in 2011. The CBYA hit a low to date of 3.92% in November 2012. Three successive monthly increases found it at 4.27% in February 2013, but it fell to 4.19% for March and 4.07% for April. Where it bottoms out is a very interesting question, fraught with potential implications for the financial health of the life insurance business. In late May 2013 we can compare the latest 4.07% rate to the U.S. prime rate of 3.25% and to the prime rate in Japan 1.2%. In the U.S., the 10-year Treasury yields

about 2.0%; that in Japan was about 0.8%. On the other hand, early indications are that the May 10-year Treasury yield is up as much as 0.30%. Perhaps the 30-year decline has bottomed out?

The foregoing must be seen in the context of WL sales illustrations generating values far into the future in 2013 using "dividend interest rates" of as much as 6%. In 2008, Northwestern Mutual, on the long record the top-performing whole life (WL) insurer – the writer owns a policy, showed the future in its sales illustrations using the dividend rate it was actually paying existing policyowners that year, 7.5%. Five years later, it is paying and illustrating at 5.6%. Where will its dividend interest rate be in 2018?

It is difficult to think the U.S. is headed in the direction of Japan with so much of our debt in foreign hands and so much underfunding of state and municipal pensions in the U.S. For fear of higher borrowing rates to satisfy our creditors, financial gurus advise us to stay away from the bond market, or at least keep maturities to, say, five years; lots of us including the writer have missed the bull market in bonds in recent years, yet so far it has not cracked. Who is to say life insurers in the U.S. can avoid the "Japan Scenario?"

Although dividend-paying WL and UL insurers guarantee 4% interest or more on older policies, the guarantee is a bit "iffy." If 4% can't be earned, dividend-paying WL insurers may reduce the mortality portion of the dividend, which is not insubstantial. There are likely exceptions, but UL insurers appear reluctant to raise the more visible cost of insurance (COI) rates to cover interest rate guarantees in the face of falling investment income, fearing litigation at a time when mortality keeps improving. But if there are threats of insurer failures, regulators might order COI increases. That there is some flexibility possible in these potential reactions to interest rates below guaranteed levels may be a good thing if you have a substantial cash value in a weak insurer.

The foregoing discussion is not so much to scare readers about their life insurance policies as it is to give some perspective on decisions about buying new policies. If the commentary scares buyers into dealing with the strongest life insurers, however, that will be good. There exists in every state a guarantee association that protects most policyholders in the event an insurer fails. (See NOLGHA.org for more information.) The limits of protection are usually $300,000 in death benefits and $100,000 in cash values, higher in a few states. A limit of $300,000 is almost trivial today, although there is evidently some chance that a death claim of more than the limit will be paid from the failing life insurer's assets. And the guarantee is not like the FDIC's, which allows a failing bank's depositors access to their money immediately. One does not want to be involved in a regulatory takeover of a life insurer; there may be a moratorium on accessing one's cash value by surrender or loan, WL dividends could be eliminated, and cost of insurance (COI) rates raised to the very high maximums on UL policies, as was true in a recent evaluation.

Given this background, how should one who is pitched for the substantial tax advantages of cash value life insurance – whole life, universal life, and variable universal life -- react? (These tax advantages maximize only when a life policy is held until death except in the case of an older buyer where future mortality and expense charges can exceed investment earnings. The

income tax rule is, generally, that if the surrender value of a cash value policy, before deducting any loan, exceeds total premiums paid, the excess is taxable at ordinary tax rates; one receives a 1099-R, the same as one receives from his pension plan.) The writer finds himself increasingly favoring variable universal life (VUL) as possibly being a better bet on the future than reliance on the guarantees of traditional whole life and universal life policies. A VUL allows the buyer to allocate her premiums, net of expense charges, to a wide array of mutual-fund-like accounts. The hope, of course, is that over time the chosen accounts will earn more than interest rates paid on WL and UL contracts. That seems a likely outcome, at least for younger buyers who must keep their cash value policies until death to avoid income taxes.

The dividend yield on the S&P 500 Index is about 2% at this writing; dividends are on the increase in 2013, although the rising stock market during the year has masked the increase when one looks at the percentage figure. That's a pretty good start toward what WL and UL may pay; it requires little capital appreciation to match the 4% or so, say, that quality mutual insurers, such as Northwestern Mutual, Mass Mutual, Guardian and New York Life, may be able to pass through to policyowners when current investment returns bottom out. Add to that the availability of low-load VUL insurers AmeritasDirect and TIAA, where almost all of your early premiums go to work for you rather than being given up in first- and renewal-year commissions and related expense allowances, and you have an attractive purchase. (TIAA's minimum VUL purchase is $250,000 until age 55 when it is $100,000; Ameritas's minimum is $100,000.)

The purchase of a VUL entails risk, of course; it is a security registered with the SEC and sold with a detailed prospectus. But a WL policy also comes with some risk of a different kind – poor performance in the future and, for buyers of policies that exceed guaranty association limits, generally $300,000, a default risk, however small it may be. There is virtually no default risk in a VUL because the investment accounts are walled off from other assets of the insurer. In order to justify the somewhat higher costs of a VUL, one must allocate a fairly high percentage of the cash value to common stocks, however, and take some market risk. But is there that much risk? If one is buying, as most do, a level premium VUL, then one is in effect "dollar cost averaging," which means that more variable shares are bought when the market is down and fewer when it is up. If one is willing to grant that stocks over twenty to thirty years in the future will trend upward, which would replicate at least 20th Century history in the U.S., then perhaps a VUL has less risk than the reader previously thought.

Many VULs, perhaps most, are sold as quasi pension plans featuring income-tax-free withdrawals and loans in retirement. A typical hypothetical VUL earnings rate used to generate future values in sales illustrations is 8%. The prime life insurance buying age is something like age 40. A sales illustration using 8% can show dazzlingly high tax-free withdrawals in retirement years: at 8% interest a dollar at age 40 is worth $10 at age 70. It's easy to see how impressive such illustrations seem to those not schooled in the power of compound interest. It is the writer's contention that many, if not most, VUL buyers in retirement years will have his "problem:" keeping his money invested well rather than having a need to take withdrawals or loans from his life insurance policies to supplement retirement income.

Three further comments on the purchase of VULs. (1) The cost of managing investment accounts within VULs can be high, as is also the case with mutual funds, of course. Over the long life of a VUL, such fees can consume enormous sums of money. Vanguard's home page notes that its fees for managing accounts are 83% lower than its mutual fund competitors. A similar range is found within VULs. TIAA has its own accounts that have reasonable fees, particularly its stock index account at just 0.10% asset charge a year: $100 a year for a $100,000 cash value invested. Ameritas has comparable Vanguard accounts. It is suggested that the VUL buyer stick to low cost stock index accounts in the absence of a considered reason to pay up for managed accounts. We frequently see ten or more investment accounts chosen, often by the agent, most of which are high cost, averaging upwards of 1% a year. Recently, a VUL had 29 accounts, each with 3.45% of policy values invested. To us, that suggests an average return at high cost; perhaps it is better to seek an average return at low cost via indexed accounts. (2) It needs to be understood that when one borrows from a VUL, sufficient shares of designated (or all) variable accounts are liquidated and the proceeds transferred to the Fixed Account (no risk) as the basis of the loan collateral. One may not borrow against variable shares. In other words, a loan does not involve risk – except that if stocks rise after selling variable shares the loan costs more than one might have hoped for; the converse is of course true in a market that falls after a loan is taken out. (3) Perhaps the greatest risk in the long term holding of a VUL is that the owner will panic when markets fall swiftly and transfer variable shares to the Fixed Account or Money Market account; this is called timing the market, and it is almost a sure loser. Obviously, someone with such a predilection should stick to WL or UL.

The context of the preceding paragraphs is mainly a younger buyer with years to go before retirement. Someone holding a VUL in retirement years may want to begin shifting some or all of his variable assets to a bond account or to the Fixed Account and remove market risk from the policy. At this time, for example, TIAA is paying 4.5% interest within its VUL Fixed Account; it guarantees 3%. But one can't move money in and out of the Fixed Account willy-nilly, as one can with a Money Market account, now paying next-to-nothing; there are rules that limit Fixed Account transfers.

II. What Should I Do with My Failing Universal Life policy?

In January of 2011 we posted a document on the CFA website that includes suggestions about dealing with an old whole life policy. It was aimed at policyholders in good health, perhaps approaching retirement age, who hold mature, good-performing, unborrowed-upon whole life (WL) policies in quality companies. WL policyholders not in good health should continue to pay premiums in cash, or by loan if necessary, using dividends to buy paid-up additional insurance (PUAs), which are bought without any premium load (deduction) and are always the best dividend option absent a special reason to do otherwise. See the link to papers of the author at evaluatelifeinsurance.org.

During the past year, we have reviewed a number of Universal Life (UL) policies that are forecast to terminate in the near future – typically in five to ten years – unless premiums are increased. Variable Universal Life (VUL) policies, in which cash values are invested in mutual-

fund-like accounts, sometimes face the same problem due to weak stock markets in the last ten years, but rising markets in 2012 and 2013 have rescued most of these. First some background.

UL policies were devised in the mid-1970s and became highly popular during the double-digit interest rates of the 1980s. They captured a large share of the market for non-term life insurance, and during that period they were used aggressively to replace traditional whole life (WL) policies to the great subsequent detriment of the victims in future years. The UL design feature that was touted widely was "transparency," meaning that via annual reports a policyowner could see, if he or she chose to look, all the elements of the monthly accounting that UL policies provided: premiums received, deductions from premiums (loads), administrative charges, cost of insurance (COI) charges, and interest credited, including the rate of interest, which reached about 10% in the mid-1980s. (COI charges for riders are often not unbundled, however.) UL insurers in the early 1980s were able to illustrate future policy values at rates of interest significantly above the interest rates that were buried in WL dividend formulas, which we call "dividend interest rates." At the beginning of the 1980s, WL insurers were passing through earnings on portfolios of investments that had been built up over two or three decades when interest rates were much lower. They could not compete with UL insurers in the illustration game because the tradition, and often regulatory rules, required them to illustrate the future based on what they were actually paying at the time of sale.

As time passed, low-yielding investments of WL insurers matured and new long-term investments were added at double-digit interest rates so that WL insurers, based on dividends they were actually paying to existing policyholders, could out-project UL insurers, and the market share of UL fell. Today, almost all WL insurers pay higher interest than do UL insurers. For example, Northwestern Mutual Life in 2013 will pay 5.6% to its policyowners while most UL are down to the minimum guarantees in their contract issued in the 1980s, often 4%.

For many years, then, UL insurers were able to compete with WL insurers; even after they fell behind they were able to illustrate the future with lower premiums than those on conventional WL policies. Although WL agents could lower premiums by using term riders, that also lowered commissions. In short, UL insurers throughout the 1980s and 1990s were able to illustrate the future with lower premiums that turned out to be unsafe. And it did not help that UL insurers, being almost exclusively shareholder-owned companies, did not, to the writer's knowledge, pass through mortality improvement gains as did the WL companies, almost wholly mutually organized – owned by the policyowners to whom all investment gains and mortality gains not needed for safety reserves were passed through in dividends. Indeed, Northwestern Mutual Life in the 21 years since 1992 has improved the mortality portion of its changing dividend formulas six times. (There are UL insurers that are mutually owned, or part of mutual holding companies; we assume but do not know that these companies have passed through mortality improvement in the form of lower cost of insurance rates.)

To explain the options that holders of failing UL policies have, it will help to explain the rather simple nature of UL monthly accounting, with particular emphasis on the actuarial concept of "amount at risk." To start a UL policy, one must of course pay a premium, which is immediately subject to a premium load (deduction), typically 5%, rarely 0%, and occasionally higher than 5%. The deduction helps pay for the state premium tax, typically a rate of 2% but with

variations by state, portions of the first year's commission and far smaller commissions paid in renewal years, and administrative expenses. The premium net of the load is deposited into a "pot," as is often visualized in UL literature. The name of this pot varies, but Policy Value is perhaps most common; other names are Account Value and Cash Value. None of these is the Cash Surrender Value, which is the Policy Value less the Surrender Charge, which generally declines to zero over 10 o 15 years and allows the insurer to recover first year commissions and other acquisition expenses out of subsequent margins.

Immediately after the first premium is paid, the "pot" is charged for: (a) the monthly administrative charge, perhaps $7 or $8 on new policy but sometimes higher; (b) the cost of insurance (COI) for the forthcoming month, and (c) and any rider costs -- for other insureds, children, accidental death, disability. We'll assume in this discussion that no riders remain, which is often the case, especially with UL policies covering those entering their retirement years – a category that typically is confronted with failing policies. At the end of the first month, the process is repeated with the addition of a month's interest (or 28, 30 or 31 days interest).

The COI charge for any month is equal to the COI rate for that month multiplied by the amount at risk. Not surprisingly, the COI rate increases with age each year, but it remains level during the policy year. With slight and meaningless imprecision, the amount at risk (AR) is the death benefit for the month less the Policy Value.

In a classic whole life (WL) policy, assuming no dividends, the death benefit is level and the cash value increases throughout life to equal the original death benefit. Accordingly, while the COI rate (mortality rate) is increasing, the AR is decreasing and offsetting, which is how the WL premium can remain level for life. If dividends are used to buy paid-up additional insurance (PUAs), the death benefit rises over time, but each PUA bought – a guaranteed single premium "policy" – has a cash value that also rises to the death benefit at the terminating age of the mortality table, age 100 for most of the 20th Century, but age 121 on post-2008 life insurance contracts. (The reader will find a fascinating story of longevity by a search for Jeanne Calment.)

To mimic the WL rising death benefit with PUAs, UL policies allow a death benefit option, often called Option B, that is equal to the "Specified Amount," or original face amount, plus the Policy Value, which is the invested fund prior to any surrender charge; we'll call it the Cash Value (CV), in what follows, assuming that policies threatened with impending termination are beyond the surrender charge period. On its face, this increasing death benefit option violates the WL notion of a reducing AR; if not switched to the level death benefit option, the owner will find the increasing costs of a level AR progressively unaffordable, especially as he or she progresses through retirement years. The writer has formed the impression over his 28 years of reviewing policies that all too often the agent suggests Option B on the not unreasonable premise that the owner will need the extra coverage as inflation continues or as her salary increases or simply to sell a higher premium form without explaining the long run dangers. Or the owner forgets any suggestion at time of sale to change the option later on. It is certainly the case that owners have poor understanding of these options.

UL Option A, a level death benefit, does not carry the AR danger of Option B, but the decades of sales with premiums set at lower than safe levels based on current interest rates above historical

norms has left many UL policies of both types underfunded. At the illustration rate at time of sale, such underfunded Option A policies looked fine, often showing increasing death benefits in later years as the illustrated Cash Value (CV) grew to the time when it forced the death benefit higher to maintain the corridor of risk amounts required under Federal law. But with lower and lower interest crediting rates as the years passed, the rate of growth of the CV over the years lessened, the AR did not decrease as fast, COI charges rose faster than originally illustrated lowering the CV, and so forth.

Eventually the CV growth levels off, the AR does not decrease, and the cost of insurance (COI) charge increases with age, setting off a "death spiral." If the CV is going down 10% a year and the COI rate is going up 10% a year, the COI charge is increasing about 20%, doubling about every 3.5 years. It gets worse if nothing is done, and the policy can rapidly approach termination without premium increases. Pursuant to the contract, however, the insurer may not terminate the policy without giving notice and usually 60 days to increase premiums.

What to do? Options for affected policyowners follow.

Those in good to excellent health who prefer to continue coverage and are willing to pay higher premiums for a better investment are likely to find that a transfer to another life insurer will work well. A good choice is TIAA (tiaa-cref.org), a top-rated life insurer that is part of the huge provider of retirement services to employees of higher education across the country, as well as many non-profits. TIAA issues its life policies without agents' commissions; and the only deduction from your premium (load) is the premium tax rate in the state to which the policy is delivered, typically 2%, which contrasts with a typical 5% (sometimes higher) with commissioned policies. TIAA issues universal life (UL) and variable universal life (VUL) contracts with minimum face amounts of $100,000 except for its VUL, which has a $250,000 minimum under age 55. Its relatively low cost of insurance (COI) rates decrease at face amounts of $250,000, $500,000, $1 million and $2 million; one would not buy a policy just under those break points. Those in excellent health with failing policies under $100,000 might find that TIAA's COI rates are so much lower than the current insurer's rates that a move to $100,000 costs little more in mortality charges, perhaps less. Choices for those at or near retirement ages with, say, $50,000 policies will find a solution is more difficult.

Those in good health who do not need or want to continue coverage should be cautious about simply cancelling the policy for its cash surrender value. More or less by definition of a failing policy, one who has not taken money out of the policy in the past and has no policy loan will likely have no taxable gain on surrender. Others need to determine from the insurer whether there is any taxable gain on surrender; in doing so, be sure to insist on being told the tax basis as well – generally total premiums paid if no withdrawals. One needs to know if there is a taxable loss in the contract, which occurs when the tax basis exceeds surrender value.

A tax loss in a life policy is not an income tax deduction, but it may be transferred to an annuity with the result that future annuity gains will be income-tax-free up to the loss transferred. When the loss has been recovered, the annuity could be terminated if another investment appeared to be more favorable. The annuity referred to here is a tax-deferred annuity, either fixed (like a bank CD) or variable (like a mutual fund). In either case, we suggest Vanguard's annuities: 1-800-

357-4720. Fixed annuities are fairly straightforward: x% interest guaranteed for y years with a z-year surrender charge; a good rule is never to buy a fixed annuity whose surrender charge period exceeds the interest guarantee period: y = z.

Variable annuities bought from a broker can be horribly expensive. Vanguard's variable annuity at this time costs an annual asset charge of 0.30% a year -- $300 on $100,000 a year – plus $25 a year if the annuity amount is under $25,000. In addition, there is the cost of the chosen investment account (s), which at Vanguard can be extraordinarily low: just 0.07% a year if the equity-index fund is chosen. Compare a total of 0.37% to the lowest total asset charges on any other insurer's variable annuity. Vanguard's minimum fixed annuity is $10,000; its minimum variable annuity is $5,000, to which can be added future funds. If your surrender value is less than $5,000, you need to have money sitting in a Vanguard account when the transfer is effected to make the minimum.

The transferred loss can also be to a life annuity, either fixed or variable. For a given sum, a fixed life annuity provides a guaranteed monthly income for life; for a (usually) small reduction in income, add a guaranteed period of income, such as 10 or 20 years, to guard against losing too much of your principal due to an early death. Keep in mind that life annuities tend to be bought by those in better than average health, not surprisingly. To compare fixed life annuities to the market, try annuityshopper.com. Variable life annuities are similar if one thinks in terms of *units* of monthly income, not dollars, with the value of each unit in dollars varying over time with the performance of the selected investment accounts.

An alternative to transferring a loss to an annuity is to make an investment out of the failing policy. Suppose you have a $100,000 UL policy with a $15,000 cash value that is headed for zero in a few years. The flexibility of a UL policy allows one to lower the death benefit, either to the minimum permitted by the contract, often $25,000, or to the minimum the insurer can state, which will be a function of federal rules that require a certain corridor of risk amount between the death benefit and the cash value. The level death benefit should be selected, the amount of which, if not the contract minimum, can depend on whether you wish to continue premiums and at what level. You want to minimize the level death benefit for the given cash value and desired premiums in order to maximize the policy's investment aspect.

What makes this option intriguing in 2013 is that most older UL policies have guaranteed minimum interest rates of at least 4%, occasionally 4.5% or 5%. By minimizing the risk amount in the altered policy, one may end up with the administrative charges and cost of insurance (COI) charges reducing the guaranteed rate by a relatively small part of the guaranteed interest rate; i.e., if the guaranteed rate is 4%, the cash value and any premiums may increase at, say, a 3% rate, income-tax-free and free of market risk. To earn anything like 3% in today's market one must take market risk: if, e.g., you purchase a tax-free municipal bond fund yielding 3% and interest rates rise, the value of your fund – your principal – will decrease.

One may either hold the reduced face amount policy until the taxable loss is recovered, and then surrender, or if interest rates remain low the policy may be held until death when any subsequent taxable gain disappears for tax purposes under long-standing federal law.

Those who are not in good health and need or want to continue coverage have limited options. We have found in our work that UL cost of insurance (COI) rates for nonsmoker policies issued at standard rates years ago run roughly at the level of 4th best nonsmoker rates in new policies; this may give the reader a notion of how he or she would fare in seeking new coverage; even 4th best class requires pretty good health.

The first option to extend coverage as long as possible at reasonable premium rates is to change the death benefit option from increasing – usually B -- to level – usually A. (A terminally ill person would of course be likely to make no changes.) Unfortunately, failing policies usually have a low cash value, so this change may not extend the life of the policy at current premium levels very much. Thus, if the cash value is $5,000 and the death benefit $105,000 -- $100,000 face amount plus $5,000 cash value – a change to a level $105,000 option does not reduce the amount at risk immediately. Over time, however, this change can be important, especially if premiums are increased so that the decline in cash values is halted or reversed. Reversion to the original face amount would be more helpful.

The second option is to lower the death benefit. UL policies are flexible as to both the insurance amount and the premiums paid. Increases in the former will usually require evidence of insurability and will also set off another round of commissions and surrender charges on the increase. (The discussion here is about policies beyond the surrender charge period; be cautious in making any reductions within this period because it normally results in a pro rata surrender charge.) Decreases may be undertaken at any time, generally. It is of course difficult for a policyowner who bought a UL policy in good faith that was represented to cover him or her for life to find it did not do so and to be confronted with a need either to increase premiums or cut coverage. To hedge one's bets, the reductions could be made in relatively small increments, such as $5,000 or $10,000 a year on smaller policies. .

Many policyholders are uncertain if they need or want continued coverage, and how much. Also, there is a tendency to think we'll die sooner than may prove to be the case; mortality continues to improve. Insurers selling life annuities use mortality improvement scales to price their contracts. One's UL insurer could, for example, run an illustration showing the reduced face amount that would allow the current premium to carry the policy to any age desired. In classic whole life policies, the safe funding level is one in which the cash value equals the face amount at age 100; it is chancy to assume one will die before some stated age, such as 80 or 90. For example, suppose one has a $100,000 level death benefit UL policy and is told that for the current premium it will go to age 95 if reduced to $60,000. While it might be better to make this reduction gradually, it would mean somewhat higher premiums. It is safer, however, to fund whatever lower death benefit is chosen with sufficient premiums such that the cash value will equal the death benefit at age 100, as in classic WL.

Policyholders faced with making difficult choices like these might find the following helpful:

> It may be better to choose to reduce the death benefit significantly now in hopes that the person insured will live a long life than to continue the higher death benefit in hopes that the insured person will die in time to make that the right choice.

There's a psychological aspect to the foregoing suggestion, but it has been greeted favorably by those we have suggested it to. If this doesn't help, maybe the following poem will:

> Whenever you're called on to make up your mind,
> And you're hampered by not having any,
> The simplest way to solve the dilemma you'll find,
> Is simply by flipping a penny.
> No, not so that chance shall decide the affair,
> As you're passively standing there moping.
> But as soon as the penny is up in the air,
> You'll suddenly know what you are hoping.

Whole life policyowners do not have the option of periodic reductions in the face amount; their choice is often either (a) to carry on with the current face amount requiring continued premiums paid in cash, paid in part or whole from policy values (dividends and surrender of previously bought paid-up additional insurance), and/or paid by policy loan or (b) to take the reduced paid-up (RPU) surrender option (which does not generate a taxable event). Under RPU, the surrender value is used to buy a guaranteed paid-up whole life policy with a reduced death benefit; e.g., at age 70 the RPU death benefit might be about 75% of the original. But with RPU dividends reinvested in PUAs, the RPU death benefit will rise and eventually be higher than the level benefit if in the latter case no premiums are paid out-of-pocket. This crossover point in years will depend mainly one's age at election of RPU.

III. Objectionable Practices in the Three Kinds of Universal Life.

Three distinct life insurance forms share the same chassis that features monthly accounting as described above: UL, VUL and IUL. IUL means Indexed Universal Life, a relatively new type of policy that has become popular in the last decade. IUL policies credit interest to the Policy Value (cash value before any surrender charge) either at the minimum rate guaranteed by contract, 0%, 1% or 2%, or if higher at the rate of increase in the equity index that is being tracked, almost always the Standard & Poor's 500 (S&P 500) index in what the writer has seen. Accordingly, if the market falls, there is no loss of interest (except of what would have been earned in a UL or WL); conversely, if it rises the policyowner is credited with some or all of that increase. The reader may sense a perfect sales pitch: eat your cake and have it too.

There are often many stock indexes from around the world to choose from. There are several methods of tracking the index that we will skip here, in part because the writer is still learning the IUL ropes. The most popular seems to be 1-year point-to-point: if the index is 1000 on the start date and a year later is 1100, 10% interest will be added to the Policy Value. The index increment is constrained, however, by the Participation Rate and the Cap Rate. The Participation Rate is the percentage of the index increment that will be credited; it seems that it

is common now to guarantee that 100% of the increment will be credited. The Cap Rate limits the index increment to some percentage; 12% seems typical. The Cap Rate is not guaranteed and may be changed from time to time in the discretion of the insurer. IUL insurers protect themselves financially – hedge their bets -- by buying options, which have a cost, of course. One presumes that the cap is set to minimize such costs.

Holders of IULs with a "point" the first week of March 2009 were capped at 12% when the market rose 91% in the next year. But this ignores the downside protection received the prior year when the market fell 48%. (Down 48% and up 91% got the index back to the starting point, roughly.) Here is a table showing the operation of IUL crediting rates for a policy issued in early March 2005 with a 12% cap and a 1% minimum guarantee.

	S&P 500 Index	Percent Change	Premium	Fund	IUL Rate Credited	Premium	Fund
Mar-05	1200		1000	1000.00		1000	1000.00
Mar-06	1281	6.75	1000	2067.50	6.75	1000	2067.50
Mar-07	1403	9.52	1000	3264.40	9.52	1000	3264.33
Mar-08	1293	-7.84	1000	4008.46	1.00	1000	4296.97
Mar-09	683	-47.18	1000	3117.39	1.00	1000	5339.94
Mar-10	1139	66.76	1000	6198.69	12.00	1000	6980.73
Mar-11	1304	14.49	1000	8096.65	12.00	1000	8818.42
Mar-12	1370	5.06	1000	9506.45	5.06	1000	10264.63
Mar-13	1551	13.21	1000	11762.42	12.00	1000	12496.39
			-11762.42			-12496.63	
		IRR =	5.31%		IRR =	6.50%	

In this example that omits the life insurance component, we see that during this eight-year turbulent period in U.S. stocks, the hedged fund on the right did its job not only in maintaining stability of one's asset –available for emergency borrowing, for example – but came out ahead. Can the reader determine why the fund on the left really came out ahead despite the lower average annual growth rate of the S&P of 5.31%? Why would a VUL, other things equal, have beaten an IUL? That leads to one of the "objections" to UL sales that we noted above.

IUL sales proposals – A recent one from Pacific Life ran to 17 pages plus five supplementary pages. Like a VUL illustration, one needs some interest rate with which to run the numbers. That is usually done by a look-back at the S&P 500 averages over 20 or 30 years, a period that included one of the great bull markets in U.S. history. The last IUL illustration we evaluated used 7.5%. IUL illustrations are both informative and complex; it's hard to believe the typical buyer understands much more than that you do well if the market is strong and not badly if it is weak. So, what's the objection?

The answer is that a critical piece of information is all-but-hidden to IUL buyers: the S&P 500 index, as well as others, excludes corporate dividends. If one buys a mutual fund or a VUL, one will be credited not only with the growth of the index but also with the dividends. In the years the writer has followed the IUL market, the S&P 500 dividend yield has been in the range of 2.0% to 2.2%. With the 2013 market surge, the yield has fallen just below 2%. Corporate dividends have been on the rise recently, although a rising market has masked the growth of dividends when expressed as a percentage.

The 17-page illustration had nine pages of "Narrative Summary" that went into detail about the policy's contract provisions and much detail about how the indexing works, including how the 7.5% rate was chosen – a 20year look-back. Each narrative section – 38 in all – was titled prominently in the left column of each page, but there was no section about the dividend exclusion. The only mention of the exclusion was found in five table headings, each table having five columns. Perhaps worst of all, the table headings were shaded, requiring the reader to peer closely.

Surely the implications of the dividend exclusion are important enough to be discussed in some detail. As he was working on this document, the writer received a call from a young lawyer requesting an evaluation of a three-year-old IUL policy. Despite spending much time trying to understand how an IUL works and despite his training in parsing "fine print," he was unaware of the dividend exclusion. So was the next client. The "objection" is not to the exclusion itself, for otherwise hedging costs would be much higher. Nor is the concern about this important aspect of an IUL limited to Pacific Life; other IUL insurers also minimize (hide?) the disclosure. A common way is to use parentheses, as in "(excluding dividends)," without amplification at all.

The writer urges those who send him IULs to buy a VUL instead; the absence of hedging costs and of agents' commissions in the case of TIAA and Ameritas can make a huge difference. The appeal of an IUL is mainly to the risk-averse, of course, but at least in the case of younger buyers it seems foolish to pay so much for the downside protection. One can limit downside risk by dollar cost averaging of, preferably, monthly premiums; in that case all one needs is an upward trend in stock markets over the likely holding period of the IUL – 50 years in the case of a 40-year old nonsmoker in excellent health?

Face Amount Charges on New VULs, IULs and ULs – Several years ago the writer began to notice that VUL expense charges had been rearranged to telescope future expense charges into the first ten policy years. I associate this change with Pacific Mutual Life VULs, but I have no idea if it was first to do so. First some background on the conventional VUL expense practices.

In a UL or WL policy, an insurer hopes to make a "spread" on the difference between what it earns on its portfolio of investments, net of investment expenses, and what it credits to policyholders. (The writer dimly recalls that in the early days of UL, the 1980s, with its double-digit interest rates, UL insurers hoped to derive their profit margins by crediting the 10-year

Treasury rate less 1.5%; today that would result in a credited rate of about 0.5% when 4% or more would have been guaranteed.) VULs, however, feature choices of mutual-fund-like investment accounts, and all the earnings of such accounts must be credited to policyholders, net of mutual-fund-like asset charges. Many if not most of those accounts are managed by mutual fund companies, and unless they include 12b-1 fees that can be kicked back to insurers, they provide no margins to VUL insurers. Such fees must be disclosed in VUL prospectuses, and many of these accounts have no 12b-1 fees. An insurer can of course run its own accounts, and many do, but the available margins from these sources needed to run complex VUL administrative systems and to comply with disclosure requirements of the Securities & Exchange Commissions are insufficient.

As a result, all VULs have had Mortality & Expense (M&E) asset charges that are applied daily to the policy values (cash or account values before any surrender charges). Traditionally, those might follow a pattern such as 0.90% in the first ten or fifteen years, somewhat lower thereafter. The 1992 Nationwide VUL the writer just reviewed still charges 0.90%. Ameritas's (ameritasdirect.com) early VUL charged 0.75% for 20 years, then 0.45%. TIAA's current M&E schedule is 0.95% until the Policy Value reaches $100,000, then 0.65% to $500,000, then 0.35% thereafter; the lower fees apply to 100% of the policy value, not just the excess.

The telescoping effect referred to above is to eliminate M&E charges and to institute high monthly face amount charges for the first ten years. The practice, first noticed by the writer with VULs, has now spread to ULs and IULs. A recent client sent us an Aviva Indexed Universal Life (IUL) sales illustration along with some annual reports for his wife's three-year-old, $1.5 million policy. In 25 sales illustration pages, no mention was made of the face amount charges; on the other hand, a certain bonus after ten years was identified. That a surrender charge applied for the first 15 years was noted, but its schedule and amount were not identified. (The surrender charge could be derived as the difference between the Account Value and the Net Cash Value.) From the annual reports, we learned that each year for ten years $3,171, a total of $31,710, was being deducted from each year's premium ($12,000) plus a 5% premium load (deduction). In addition, there was a $29,810 surrender charge. The first year's cost of insurance (COI) charge came to 2.4 times what one-year (automatically) renewable term life would have cost.

In another recent evaluation, John Hancock levied face amount charges of $16,256 in the first ten years on a relatively small $260,000 policy issued to a female age 77; in addition there was an 8% premium load (deduction) on premiums of $12,000 a year. The 15-year surrender charge was just $4,000, however. The policy evaluated terribly for ten years, terrifically thereafter. Perhaps the trade off is worth it if one is 100% sure to stay the course.

It has always been the normal role of the explicit surrender charges in UL and VUL policies – WL has implicit, similar charges -- to allow the insurer during the surrender charge period time to recover startup expenses with (usually) COI rates higher than term life insurance. These expenses include first-year and renewal-year commissions and related sales expense allowances, as well as insurer start-up expenses, including the often expensive medical evaluations. The

insurer is thus guaranteed to recover its investment in new business and its profit margins whether or not the buyer continues his or her policy. And if the charges are high enough, profits on terminated policies in excess of the insurer's needs can be invested and used to subsidize later costs of doing business for those policyholders who "persist" in continuing their policies, that is, do not "lapse" them. In life insurance lingo this is "lapse-supported pricing," which can make an insurer's policies look more attractive in the long run.

Life insurance lapse rates on cash value policies are rather high; some might say notoriously high. The most recent "persistency study" of the Society of Actuaries covering policies during 2007-2009 showed the following for UL policies: after 5 years, 27% had lapsed; after 10 years, 41%; after 15 years 52%, and after 20 years, 61%. Larger policies have better persistency; there is no breakdown for UL, but whole life (WL) policies of $500,000 or more issued in the prime selling ages of 40-49 showed these lapse rates: 25% after 5 years; 39% after 10 years, 49% after 15 years and 57% after 20 years. Perhaps the reader can sense that when the lapse rate is added to the interest rate earned on lapse-supported profits there is a doubling up effect; if investment earning after expenses are 4%, the lapse profits can be earn something like 8%.

Adding the face amount charge to the normal mix described in the preceding paragraphs generates substantial sums to be used to lower long run costs. Sales regulations for UL and IUL policies supposedly limit lapse-supported pricing, but they seem to have little effect.

Ideally, sales illustrations that include face amount charges coupled with surrender charges should disclose conspicuously something like:

> This policy has very high charges in the first ten years in order that charges thereafter can be very low. Accordingly, you should not buy this policy unless you are sure you can keep it indefinitely.

The chances of such a disclosure requirement being adopted by insurance commissioners in the face of life insurer opposition are between zero and infinitesimal. The reader may reflect on whether he or she would buy such a policy if given such a disclosure.

Caveat emptor.