FIELD NOTES

Universal Life Insurance

The basic concept behind universal life is so simple that very few people understand it. It is almost as simple as annual renewable term insurance, which is essentially what UL is, with a side fund added. Any premiums paid are added to the fund along with interest, and charges for the ART (mortality) and several other expenses are subtracted at regular intervals. As long as the fund is sufficient to pay the charges, the policyholder can pay any premium he wants, or none at all. In practice the policyholder usually doesn't remember that, and regularly pays the same premium until notified that he has to pay more to keep the policy in force. Most UL is (understandably) sold at the "target premium", which is the maximum premium that is fully commissionable, and the target premium is usually high enough to be sufficient for 15 to 20 years before it is necessary to pay a higher premium.

Simple enough, so what is the problem? There is a big problem. Ask a policyholder what the product costs, and he will tell you the premium. Ask how long it will stay in force, he will say "as long as he pays the premium". It is unlikely that most policyholders realize that they have purchased a product on which the cost increases every year. Since the premium doesn't change that increase is hard to discern on the annual statements in the early durations, and even in the later unless the policyholder notices that his cash value is decreasing. The notice from the company that the cash value is all gone and it will take a higher premium just to pay the charges one more year, much less create any cash value in the future, will make an unhappy policyholder, a replaced or lapsed policy, and a problem for the industry. There is further discussion on this page, but no solutions are offered. There may not be any. Once a UL is sold the past is prologue.

In response to these worries, the industry has been busy embellishing the UL concept, offering contract provisions like level mortality charges and secondary guarantees and *shadow accounts*. The no lapse guarantee promises what the policyholder thought he was getting all along, that if the stated premium is paid the policy will not lapse for a stated period, or perhaps, ever. If forever, has the UL has been changed into whole life? "Not exactly". The policy may stay in force for life, but the cash value in the late durations is zero or negative. Since the cash value of WL increases in those durations and endows at age 100, there is a significant cost difference to the company. This difference is not, however, sufficient to account for the full difference in the premium. Some piece is missing. The regulators say it is the reserve, and much of the regulatory activity is trying to plug the holes faster than the industry can think of another name for the game.

What is actually going on with all of these provisions is the shifting the interest and mortality risk, which UL surreptitiously moved to the policyholder, back to the company, but with no change in the charges. In the end, the missing piece will probably be company profit. There is another piece to the puzzle, the fact that UL almost always lapses when it either runs out of gas or gets to the end of the guarantee period, while whole life will usually persist. There is not much question on which is better for the policyholder, but it is not all that clear from the company standpoint.

Notes	Discussion
What makes universal life hard to grasp at first is that no other insurance is offered unbundled like that. With other insurance products the actuary figures out the elements and determines a fixed premium and fixed benefit. You don't get to pay any premium you want on your car or home insurance, or on regular term or whole life. The natural assumption by the average buyer of a UL policy is that he is to pay a certain premium and has a certain face amount of coverage, and maybe the values are one of the three he was shown in the illustration.	Does average buyer of universal life understand that there is no way to tell how long he can have the face value coverage he thought he bought for the premium he thinks he will pay? The illustration required to be presented to the policyholder projects the interest and charges at three levels, the guaranteed rates, the current rates, and one that is approximately half way in between. It is unlikely that any of the three prescribed scenarios will describe exactly what happens over the life of the policy. The level premium will of course keep the policy in force for at least the period projected with the guaranteed rates, but that period is so short as to be meaningless. The other two projections assume a fixed interest rate when in fact the rate is always changing with the market. So the UL mechanism is simple, but no one has any idea how the values are going to turn out. To a large extent the risk of future interest rates and the company's mortality experience, and to a lesser extent, its expense level, has been shifted from the company to the policyholder. That is not necessarily a bad deal, as long as the policyholder understands it, since less risk to the company should ultimately mean less profit to the company, and a higher return to the policyholder. Much like par WL is supposed to turn out. Interestingly, I have never discussed this with any manager who thought that shifting risk to the policyholder was going to lower company profit. The assumption is usually the reverse.

The **universal life** provision of a dual set of rates and charges, the "current" and the "guaranteed", create some questions. Variable interest crediting rates are a familiar aspect of fund products, but variable charges, particularly for mortality, are somewhat unique to UL and therefore obscure. The minimum interest rate is pretty well established by that visibility at around 4%, [times change, as now the guarantees are more like 3%] and the extravagant first year offers can't be illustrated. But mortality and other charges are rarely a competitive point and may be out of line with experience.	There is usually a significant margin between the current charges for mortality and expense and the guaranteed charges, primarily because the charges are small as a percentage of premium and the sale is not sensitive to the guarantees. Moreover, if the company increases the charges, the premium usually does not change. The period the policy will stay in force at the current premium just gets shorter. Therefore the main problem to watch for is the expectation created at the point of sale. Also check for compliance with the illustration regulations, although compliance alone will not solve the expectation problem if the initial premium selected is inadequate to carry the policy for the implied period. It may appear that the company has complete discretion in setting the mortality and other charges, and may be tempted to move those to the maximum to increase otherwise thin profits. If this was unsupported by higher than expected experience, the reasonable expectation of the policyholder might support a *class action*. I haven't seen this exact point yet, but a lot of the early sales of UL have reached the point of imploding, and this will be a growing problem.
It has been about 20 years, give or take a few, since the sales of UL took off. Most sales at target premium were calculated to last about 20 years, give or take a few, before the premium payment needed to increase to avoid lapse. In the last few years the problem of the **UL policy crashing** has been growing. When the cash value of a UL is finally used up, the charges have exceeded the premium for a number of years, the policy	The **crashing UL problem** goes deeper than just the sizeable increases in the premium required. In the years since the policy was sold, the charges on new policies have been decreasing. Mortality has improved, underwriting by "preferred" health has been introduced, and competition has squeezed the IRR companies will accept. Interest crediting rates are irrelevant when there is no account value. It is tough to make a conservation call when you know that the policyholder would be better served by replacing the policy. And if you are the agent, you may consider it your duty to so advise the policyholder. You also know the first year commission on a replacement is a lot more than any conservation incentive. Can you object when an agent includes in his conservation effort an alternative for a replacement policy with different company? When you try to conserve a true level

staying in force by consuming the cash value. When the policy finally enters grace and the company realizes it is time to contact the policyholder, it is generally too late. The increase in the premium necessary to just cover the charges in the current year, much less build back some value, is more than many policyholders will accept. Worse, even those that agree to pay more will find that the policy only lasts a few more years before another increase is necessary.	cost policy, the advancing age of the policyholder more than offsets the generally lower premiums available. Not so with UL, which is not a level cost policy, just a level premium one, for a while. So as a company, what do you do about your crashing and lapsing UL in force block? Most are just holding their ears, and trying to write enough new UL to fill the hole as the old ULs get replaced. Suppose you don't see much future in writing what amounts to 20 year term insurance and calling it "permanent"? Particularly if you are now hearing complaints from a growing block of frustrated policyholders? What else can you do? Your own recently designed UL policies are lower cost than most of the UL you have in force. Should you offer the new product to replace the crashing policies? If you do, how do you justify not offering the new product to everyone who hasn't crashed yet, but who have charges which exceed the premium and are eating into the policy values? How about those getting close? You have policyholders, but you have stockholders too. *Scarlett: I can't think about that right now. If I do, I'll go crazy. I'll think about that tomorrow.*
The response of the industry to the problems the buyer has in understanding what he bought has been, logically enough, disclosure. Thus the detailed illustration rules showing values projected at current, at guaranteed, and somewhere in between. A careful study of the illustration by the prospect is calculated to appraise him of the problems discussed here. A *pretty conceit*.	There is something of Alice in Wonderland in the illustration rules. It is permissible to sell an illustratable product as long as it is certified that there was no showing of the non guaranteed elements. Just how do you do that? If it is really possible to sell someone a UL policy and tell them only the face and the premium, and nothing about the values or how long the policy will last, it would appear to prove my point about what the applicant is thinking. Another point. For the last year or so the current rates have been essentially the guaranteed rates. The illustrations must look terrible. The fact that you are not hearing much about that from either the agents or the policyholders is a pretty good indication that the prospects are really not looking.
Universal life is usually *referred to* as "permanent"	From the standpoint of the policyholder, an advantage of UL over term is the tax free nature of

insurance, contrasted with term which is "temporary". But is it? UL looks a lot like annual renewable term with a side fund. The mortality charge on UL increases every year, so how long the premiums can remain "level" depends upon the initial premium, but it is rarely set high enough to last 20 years, much less a lifetime, and it can be issued at a minimum premium that accumulates no cash values and so lasts only the first year without a premium increase.	the interest credits to the fund, the "inside buildup". This was an idea carried over from the tax advantage accorded the cash values of whole life, and while conceptually dubious, is probably a permanent feature. No pun intended. Whether the credits to the fund should be taxable was hotly debated when UL was first introduced and was uncertain for several years. Once the tax preference was established, the next step was a rush to sell it as a tax gimmick, showing large sums poured into the "cash value" and accumulating tax free. This of course led the IRS to counter with complicated rules which limit the amount that can be held in the fund without losing the tax advantage. Today the tax preference involved is not significantly different from that available on an old fashioned whole life policy.
Universal life is significantly more expensive than an equivalent ART with just about any side fund or annuity commercially available. And yet UL is the most sold life insurance product in the United States, and the ART is the least. The tax free inside buildup is a factor, but is certainly less important than is the huge difference in the agent's commission and the difficulty of comparing the cost of the coverage. From the standpoint of the company, you generally hear that there is no choice, it is what the agents want to sell. This	The first year commission on a UL normally exceeds 100%, while on an ART it is 40% or less. On annuities the rate is around 5%. The UL commission is paid on target premium, which means that a good chunk of the premium that is destined for the side fund is commissionable at that rate. For the agent the choice is obvious. Even though the issuer has a higher acquisition expense with UL, the probability of recovering it may be greater than with a term policy. It is extremely difficult to compare the cost of one UL product to another, so the cost to the policyholder is not obvious. With term what you see is what you get, and competition has driven the cost to a point in many markets where it is less than the pure mortality cost. This probably explains the company preference for selling UL. That, and the fact that the management gets to count it as "permanent" rather than term, with the *implicit assumption* that permanent is the more valuable sale. With UL, acquisition cost can be recovered from the interest spread on the account value, from mortality charges, and from other expense charges. The

stands out in the workplace market, where the relatively small sale and the inappropriateness of shifting the risk to the policyholder should indicate a whole life sale. But most workplace sales are UL, albeit with a lot of fixed premium designs.	once common up front fees have been largely replaced for competitive reasons by the surrender charge. On an illustration both the account value and the cash value show, the later being the former less that surrender charge. The account value is *largely fictitious* in the early durations, but certainly makes the illustration look better. Further, the primary focus is usually on the values at later durations such as 20 years or age 65, so the surrender charge product illustrates well, as the charge has expired by that time.
Universal life can be purchased with the option of level mortality charges for life. This seems a bit of an oxymoron for the policyholder, as it sounds comforting while it changes nothing at all. If the premium resulting from the level charge option is paid without electing the option, the policy should remain in force at that premium for the same duration. It is hard to see how the policyholder could benefit from paying a higher charge in early years rather than just putting the incremental amount in the account value for later use. It does however create the opportunity for the company to profit from early lapses, or to use the lapse support introduced by the level charge to lower charges.	When the mortality charge is leveled, the company is overcharging in the early years and undercharging later. Had the charge not been leveled, that overcharge amount would have gone into the account value of the policyholder, but with this option it goes to the company. While the company will establish a reserve (in addition to the reserve of the account value), and that reserve may create a cash value, all of the interest earnings on the overcharge go to the company, rather than just the spread. In addition that reserve will be released to the company on policies that lapse, which is added profit (or reduced loss, if acquisition expense hasn't been covered). The added reserve release introduces *lapse support* to the product. If that is used to lower charges in the product design, the temptation is to overestimate the lapses in order to offer a "more competitive" premium. Then the company is likely to have lower than projected lapses and thus lower than projected profit.
A universal life policy will lapse when the "fund" is insufficient to pay the	Companies that do not allow the surrender charge to become impaired will take the surrender charge when the margin of the account value over the

charges, but which fund is that, the account value or the cash value? The account value less the surrender charge is the cash value, the amount the policyholder can withdraw. Put another way, if the fund value goes below the surrender charge, will charges be paid from the remaining fund, or will the policy lapse? Many policies do not clearly define which, and you can find companies doing it either way. While it is clearly better for the policyholder to allow charges to reduce the fund below the amount of the surrender charge, it is not so clear which is better for the company.	surrender charge is insufficient to pay the current charges. Companies that allow charges to be satisfied from the account value will earn the same amount in continuing charges over time. The difference is primarily the extra death claims incurred because the policy stays in force longer. Offsetting this extra cost is the additional cash received if the policyholder is still paying premiums (but not enough to cover charges), and the possibility the the policyholder may reinstate premium payments (or increase them) in the additional time the policy stays in force. Some would make the value judgment that since the policyholder did not specifically elect to surrender, the company should provide the extended coverage for which it has received premiums. There is something about the company grabbing the surrender charge if premiums are inadequate that doesn't feel right. Since it is probably a push for the company either way, companies that lapse the policies when the account value reaches the surrender charge are acting contrary to their own interests as well as that of the policyholder. This is called *shooting yourself in the foot*.
The inherent uncertainty of how long a policy will remain in force at the issued premium led to the development of *secondary guarantees* that the policy will stay in force for a stated period even if that premium proves to be inadequate. This raised two critical issues: does this require additional *reserves*, and if so, does that yield *nonforfeiture values* for the *policyholder*?	Every company's illustration software calculates how long a policy will stay in force without increasing premiums, given the premium and the interest and cost elements. It will show projected duration at the guaranteed rates, at the current rate, and half way in between, roughly. Let's say the projection shows 4 years at the guarantee and 17 years at the current. In the secondary guarantee, the company says "never mind", we guarantee it will last 20 years (or to age *85,90, or 100*) no matter what the actual performance of the fund. The cash value is allowed to go negative if necessary. The original purpose of the secondary guarantee and its successor devices, such as the shadow account, was to provide additional certainty without having to put up the reserves and cash values that would normally result. The rules were updated (AXXX reserves) to prevent that, but the

	guarantee is here to stay. Recommended reading is a *Milliman Research Report* on funding AXXX reserves on UL with secondary guarantees and shadow accounts, just for the preliminary discussion of the devices and the description of the reserve calculation.
A *shadow account* on a UL policy is a stand in for a secondary guarantee. The "real" fund is the one with a crediting rate and charges that will determine the account value. The shadow fund is another bookkeeping fund, with a different set of crediting rates and charges, and the policy doesn't lapse until the shadow fund is depleted, even though the real fund was depleted earlier.	The policyholder can't cash in the shadow account. The only purpose is to provide the secondary guarantee without saying there is a secondary guarantee. Once it was decided that the reserve regulation, then XXX, applied to secondary guarantees, it was hoped that it wouldn't apply to the next contrivance. Why is so much creativity and energy spent trying to avoid higher reserves? Even companies that are not close to the ragged edge on statutory surplus try to avoid putting up more reserves than the minimum. You pay dividends out of surplus. Statutory earnings are decreased by the change in reserves. But in my view, the major driving force behind these devices is to justify lower premiums without reducing the ROI to the company. The ROI profit measure counts an increase in reserves as an expense, just as if it was paid in real dollars. So *return to the question* of whether a profit measure that includes the present value of a reserve is valid for decision making. It is not unusual for the board, or top management, to make a rule that every product must have at least X% ROI. If they wish to control profitability, they need to dig deeper than that.
Notwithstanding all the issues involved in UL **secondary guarantees**, it is easy to see why agents want them available. There really isn't much a buyer of UL can be sure of. Maybe the premium and face will be level for 4 years, or 20 years, or	One sure source of future problems is the **faux secondary guarantee**. This provision says something like everything in this policy is guaranteed and this policy will remain in force for the full 20 years without change in premium or face, as long as the conditions in section X are met. I have seen policies with a section X that I am pretty sure no one can understand, but that I THINK says that the policy will remain in force as long as the cash value fund is sufficient to pay all the charges.

some period in between. That does not make a very satisfying presentation. An agent would rather say, "forget all that, you have a 20 year guarantee as long as you pay this premium".	Since that goes without saying, nothing has been promised. But it is doubtful that the agent or the policyholder knows that. Ultimately the court is going to say that the language has to mean something, and so will enforce the secondary guarantee. So the reserves are understated and the design margins may not be there. It is also simply not cricket.
The focus on this site is always on the insurance company viewpoint. From the perspective of the insured, *Peter Katt,* a fee only insurance advisor, notes in the article quoted at the right that the buyer should weigh the advantages of a UL with a no lapse premium guarantee against the risk that the insurer may become insolvent. Katt's article, and the concerns he cites from Moody's Investment Services, Fitch Ratings, and Joseph Belth's The Insurance Forum should be required reading.	*Peter Katt, Journal of Financial Planning - November 2004*: *My July 2003 Journal of Financial Planning column discussed universal life policies with no-lapse secondary guarantees. I referred to them as no-lapse premium guarantee (NLPG) policies. These NLPGs have very exaggerated guarantees and probably rely on policy lapses to provide a margin of safety for the companies selling them. If they don't get the number of lapses anticipated and interest rates don't soar, these policies won't be profitable for these companies. This is especially the case for the most aggressively priced NLPGs.* On my page dealing with *lapse support*, I don't discuss UL policies, which normally would not have this characteristic. But once you make a no lapse guarantee you are subject to a later duration in which premiums are likely to be inadequate (or why the guarantee?) and are obviously exposed to that set of risk.
It seems that **Universal Life should tend to be less profitable** than coverages where the company assumes more of the risk. The spread between the current rates and the guaranteed rates on both interest and mortality defines the extent that the company has shifted the interest risk and the mortality risk	Less risk generally means less profit, even though it is doubtful the policyholder understands how much of the risk has been shifted to him. To see this working, look at the assumptions the actuary builds into the pricing. On whole life he must grade the assumed interest rate down to 4 or 5% over time and make sure mortality priced high enough to take care of the inevitable deviations. In other words, he has to put some padding in the rates. If the padding proves unnecessary, as it usually does, it becomes profit. On UL the actuary knows the interest rate credited can be reduced later, so the current rate will be at least the current new

to the policyholder. The pricing actuary is relieved of being conservative about the future, and that, coupled with marketing pressure, will probably lead to the current charges being set as low as possible.	money rate, and probably higher, to meet "competition". Likewise the mortality charge will be the lowest that can be reasonably supported since it can be raised later. This tendency is probably exacerbated by the knowledge that future changes will be relatively painless to the policyholder, and perhaps not even noticed, because they do not immediately change the premium being paid. The effect, however, is to reduce the profit currently, and almost certainly over the life of the product.
Universal life is a lot like a participating policy, in that the odds are the total premium outlay by the policyholder will end up less than if he had purchased a fully guaranteed product like regular whole life. The problem is that the odds also are that the policyholder will end up dropping the policy if the company has to catch up later for low ball rates at issue, and will be without coverage when it is needed.	The great flexibility of UL is said to be one of its greatest virtues, but you have to wonder if that is really a curse. The policyholder is looking for permanent coverage and not expecting price increases later, and the company without a niche feels forced to compete with current charges so low that they won't be sustainable unless everything works out the best possible way. The ability to jack up the mortality charges later won't recover current profits, and by that time the policyholder is not going to remember to be grateful for the good deal he had all along. So the flexibility of UL has made it much easier to take chances on the future. That is somewhat ironic for the life insurance business, which is in the business of reducing the uncertainty of the future. Not an easy problem to solve, but the first step is to be fully cognizant of it.
Universal Life, with its flexible funding vehicle, can be used for money laundering. Very large size and foreign residence can be a tip off. As usual, some common sense rules are needed to protect the company. The anti money laundering provisions of the Patriot Act are *discussed* in the Regulation section.	While no company can defend itself completely, systematically watching for situations that will look foolish if a problem is discovered later is not hard. Do you have a small shop keeper in Afghanistan or the U.A.E. looking for a million dollar policy and wishing to fund a number of years of premium in advance? The range of problems is so obvious that the company is going to look very bad, and may have committed a crime, when it turns out to be a money laundering situation, or worse. Regular underwriting principles are a first defense, but there can be pressure to shortcut to "get the business".