



# DUE CARE BULLETIN

April 2009

## Choosing Life Insurance Products in Today's Volatile Economic Environment

Purchasing life insurance in the high net worth marketplace is a complex and at times, difficult process. From product selection to product performance, there are many factors to consider when buying life insurance. The ongoing volatility in the financial markets can create additional challenges.

This M Due Care Bulletin will address the following questions:

- What should clients be aware of when considering various product types?
- Are there ways to mitigate the uncertainty of policy performance in this environment?

### Insurance is Risk Transfer; But What are the Risks?

Insurance is risk transfer. In its purest form, **Term** insurance, the risk of death (i.e., mortality), is transferred to the insurance company. The premium and death benefit for the policyholder is known and guaranteed. If mortality results are better than expected, the insurance company makes an additional profit beyond the original assumptions. If mortality results fall short of expectations, the insurance company's profit declines. Policyholders have little uncertainty (other than the future claims paying ability of the insurance company), but also no upside if results are better than expected (e.g., reduced premiums), and no flexibility to access value prior to death should needs change.

Over the past half century, the industry has developed new forms of insurance in which the policyholder shares some of the downside risk and upside potential with the insurance company. For example, in Participating **Whole Life** (WL) contracts, policyholders share in favorable mortality, interest, and expense results through policy dividends, which can be used to suspend premiums or increase the face amount. Policyholders also assume some downside risk since dividends are not guaranteed. If experience is worse than expected, dividends may be reduced, potentially requiring additional premiums. However, there is a guaranteed floor to downside performance via the base contract.

Whole Life then gave way to **Universal Life** (UL). With UL, the same risks and opportunities are shared with the policyholder, but they are "unbundled," and more transparent than the "black box" dividend calculations inherent in Whole Life. UL also includes a guaranteed floor for downside performance.

**Variable Universal Life** (VUL) takes the risk and opportunity sharing even further. VUL allows the policyholder to almost completely assume the investment allocation control and investment risk (i.e., no guaranteed floor for investment earnings credited to the contract); in so doing there is a significant upside and downside potential to policy performance. In addition, since the account value of VUL is held in a Separate Account, it enjoys a degree of protection from insurance company creditors that does not apply to policies invested in the General Account for WL and UL. Note that a Fixed Account option is generally available with VUL; funds allocated to the Fixed Account are included in the General Account and therefore do not have creditor protection.

**Equity Index UL** (EIUL) is essentially a UL/VUL hybrid, with a risk transfer profile that is a combination of the two (equity market participation but with a guaranteed floor and possibly a cap on earnings credited).

*Life insurance due care requires an understanding of the factors that impact policy performance and drive product selection.*

*M Financial Group continues to lead the industry in life insurance due care and client advocacy, providing valuable insight and analysis that delivers significant value to clients.*



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**No-Lapse Guarantee** Universal Life (NLG), with its guaranteed premium and death benefit, acts much like Term insurance (but with guaranteed coverage for life).

Even in cases where the policyholder assumes some risk, there is often a guarantee provided by the insurance company. For example, Universal Life policies have a guaranteed minimum interest rate, and guarantee mortality and expense loads cannot exceed a specified maximum. It is important to keep in mind that product guarantees are subject to the claims-paying ability of the issuing insurance company. The following table summarizes the different policyholder risks/opportunities and guarantees by product type.

Which Risks/Opportunities Are Assumed in Whole or Part by Life Insurance Policyholders						
Risk Type	Whole Life		No-Lapse Guarantee <sup>1</sup>	Universal Life	Equity Index Universal Life <sup>2</sup>	Variable Universal Life <sup>3</sup>
	Non Par	Par				
Interest Earnings	No	Yes <i>(With minimum guarantee)</i>	No	Yes <i>(With minimum guarantee)</i>	No	No
Equity Gain/Loss	No	No <sup>4</sup>	No	No <sup>4</sup>	Yes <i>(With minimum guarantee, and potentially a cap on upside)</i>	Yes
Mortality Experience	No	Yes <i>(With maximum guarantee)</i>	No	Yes <i>(With maximum guarantee)</i>	Yes <i>(With maximum guarantee)</i>	Yes <i>(With maximum guarantee)</i>
Expense Experience	No	Yes <i>(With maximum guarantee)</i>	No	Yes <i>(With maximum guarantee)</i>	Yes <i>(With maximum guarantee)</i>	Yes <i>(With maximum guarantee)</i>

<sup>1</sup> Risk transfer refers to guaranteed premium and death benefit, not account value. Account value is impacted similar to UL.

<sup>2</sup> Assuming funds are allocated 100% to an index strategy. Funds allocated to a Fixed Account option have the same risk profile as UL.

<sup>3</sup> Assuming funds are allocated 100% to an equity fund. Funds allocated to a fixed account option have the same risk profile as UL.

<sup>4</sup> Most, if not all, General Accounts have minimal equity exposure, therefore the equity market should not materially impact General Account performance.

With all of the negative financial news in the media, it is easy to forget that fundamental insurance concepts still apply. Insurance is transfer of risks but also a transfer of opportunities. The risks/opportunities transferred vary depending on the type of policy, and can include mortality, interest, investment selection, investment return, and expenses.

The appropriate product choice should, as always, be based on the policyholder's comfort with the risks/opportunities involved. In general, as the policyholder takes on a greater share of the downside risk, they increase their share of the upside potential. Better than expected experience can result in lower premiums or higher surrender values and death benefits than illustrated at issue. Worse than expected experience can result in higher premiums or lower surrender values and death benefits than anticipated at issue, or even a policy lapse (if additional premium is not paid).

## Considerations for Financial Flexibility (Cash Value)

In addition to the amount of required premium, an important consideration is the flexibility of the chosen product—that is, the ability to access value in the contract prior to death (i.e., cash value), should the policyholder's needs change over time. Although insurance is a long-term investment, having access to cash values can provide emergency cash or income if needed. Additionally, cash values can be used to fund a policy exchange into a product with better potential performance. Withdrawals will decrease the death benefit and cash value and may be subject to policy limitations and income tax.

Different product types, and even different products within a product type, can have significantly different levels of cash values. Some products have surrender charges, which can significantly reduce cash values in the early policy years; other products contain cash value enhancement riders, usually available for an additional fee, which typically increase cash values in the early policy years and slightly reduce cash values in the later policy years. Of the different product types, NLG typically has the lowest cash values, often producing zero cash values in the early policy years and zero cash values in the later policy years. There are some NLG products that provide enhanced cash values, but the offset is increased guarantee death benefit premiums.

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## Product Planning and Risk Mitigation

The current economic environment makes it even more critical that policyholders understand product type risks and opportunities, and plan and review accordingly. At the time of purchase, it is important to understand risks and guarantees, which may be quantified with illustrations run at downside scenarios (including guarantees). Understanding the impact of funding policies at different levels, including more conservative premiums that will provide a cushion in the policy to withstand a downturn, is also beneficial.

For insurance that has already been purchased, inforce illustrations can provide an early warning as to whether adjustments in funding or death benefit, or even a policy replacement (i.e., 1035 exchange) may be necessary. Inforce reviews may need to be more frequent for aggressively funded policies or for products that contain more risk. Note that inforce reviews may show actual policy performance that is ahead of schedule, providing opportunities for reduced future premiums or for taking cash distributions.

## Life Insurance Company Due Care

Company financial strength is always an important consideration, but it is even more critical in today's environment. Reviewing and understanding insurance company financial strength ratings help clients and their advisors become comfortable with the claims paying ability of the company. Consider the value of diversifying your insurance across multiple insurance companies to spread the claims paying risk. Some advisors may even provide ongoing reviews of insurance company financial strength, a valuable service in the current economic cycle.

## M Financial Group

Due to the complexity of purchasing life insurance, and the external factors impacting the life insurance industry, consider working with Gateway Financial Group, a Member Firm of M Financial Group. Regardless of the chosen product or strategy, decisions are enhanced when made in conjunction with an insurance advisor who understands the complexities of the landscape and the mechanics of the products available. Inforce service—which is provided after the plan is implemented and policies are purchased—is also critical. In a volatile environment, it is essential to continuously monitor policy performance and assess the impact of emerging trends.

Gateway Financial Group and other M Member Firms are particularly well positioned to navigate these uncertain times and deliver these valuable services:

- M Financial is the founder and leading advocate of insurance company and product due diligence.
- M Financial's emphasis on inforce management (i.e., treating inforce policyholders as well as new policyholders), including involvement in inforce repricing improvements—especially in the M-proprietary product portfolio—afford more transparency, control, and communication of potential repricing actions.
- M Financial has a multi-insurance company platform with financially strong insurance companies providing the ability to diversify cases across multiple insurance companies.

Remember that life insurance can be tailored to meet your risk profile and can be an efficient tool for transferring and mitigating risks, especially in today's environment.

*Variable universal life policies are offered by prospectus only, which can be obtained by calling 412.497.1750. The prospectus contains information about the product's features, risks, charges, and expenses, and the investment objectives, risks and policies of the underlying portfolios, as well as other information about the underlying funding choices. Please read the prospectus and consider this information carefully before investing.*

## For More Information

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