

# 3

## *Variations of Whole Life Insurance*

### **Overview and Learning Objectives**

Chapter 3 explores the many variations of permanent life insurance, most which have evolved over the last 25 years or so. Creative market forces and client needs have merged to enable companies to design products that allow advisors to tailor their solutions to the specific needs, goals and circumstances of their clients.

By reading this chapter and answering the questions, you should be able to

- 3-1. Understand the concept of endowment life insurance and be aware that many endowment policies are still in force.
- 3-2. Understand the adjustable life policy design.
- 3-3. Describe the features of variable life and understand its dual regulation status.
- 3-4. Be aware of the variable adjustable life policy and its features.
- 3-5. Describe the universal life policy and explain how its features differ from whole life policies.
- 3-6. Describe and understand the current assumption variations of life insurance.
- 3-7. Describe and understand variable universal life insurance policies.

## **Chapter Outline**

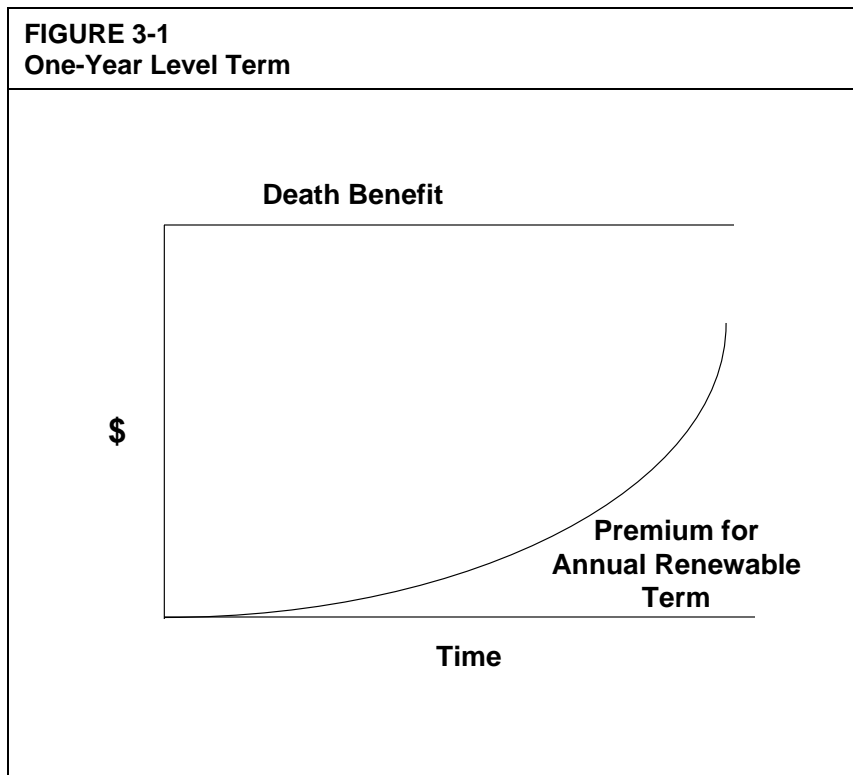
Whole Life Variations	3-3
Endowment Policies	3-3
Adjustable Life Insurance	3-7
Variable Life Insurance	3-8
Variable Adjustable Life Insurance	3-14
Universal Life Insurance	3-15
Current Assumption Whole Life	3-27
Variable Universal Life	3-32
Chapter Three Review	3-39

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# Whole Life Variations

## Endowment Policies

As mentioned previously, level premium term insurance to age 100 is identical to whole life insurance in the use of the level premium technique. There is also another type of life insurance that is identical to whole life insurance—endowment at age 100. However, the majority of endowment contracts mature at ages less than 100. At earlier maturity dates they are not identical to whole life policies.

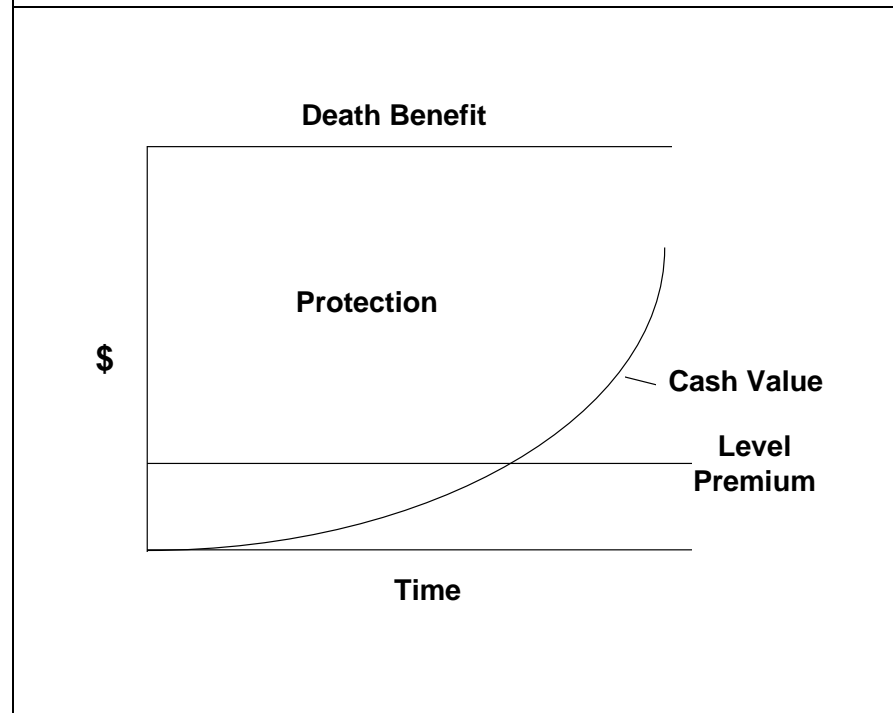


*Endowment life insurance* policies are a variation of whole life insurance. They provide level death benefits and cash values that increase with duration so that a policy's cash value equals its death benefit at maturity. They also allow the purchaser to specify the policy's maturity date.

A whole life contract provides a survivorship benefit at maturity (i.e., age 100) that is equal to the death benefit that would have been payable prior to the insured's age 100 (see figure 3-2). Endowment contracts merely make the same full survivorship benefit payable at younger ages. Endowment policies are available for a set number of years or to a specified age.

The endowment contract was designed to provide a death benefit during an accumulation period that is equal to the target accumulation amount. Purchasing an endowment policy with a face amount equal to the desired accumulation amount assures that the funds will be available regardless of whether the insured survives the target date.

**FIGURE 3-2**  
**Whole Life**



Sales of endowment contracts were declining in the United States even before the federal income tax law was changed in 1984 to take away the tax-free buildup of flexible-premium endowment policies' cash value. Congress was concerned that life insurance policies (especially endowment and universal life) with high cash values relative to their death benefit amounts were being used as a tax-advantaged accumulation vehicle by the wealthy. Congress enacted a test for flexible-premium life insurance in *IRC Sec. 101(f)* that eliminated the tax preference that flexible premium endowments previously enjoyed, although it retained the preference for policies in force before 1985. Subsequently, *IRC Sec. 7702* extended the test to all life insurance policies, including fixed-premium endowments, entered into after October 22, 1986. *IRC Sec. 7702* defines the two tests—the cash value accumulation test and the guideline premium and corridor test—that must be met in order for the death proceeds of life insurance contracts to be fully excludible from the beneficiaries' income. These tests were introduced to control the amount of premium that may be paid into a life insurance contract and still maintain the tax benefits of the Internal Revenue Code afforded to life insurance contracts.

Since 1984, sales of new endowment contracts have been very limited. While contracts are still available from a few insurers, most new sales are for policies used in tax-qualified plans where the tax treatment is controlled by other factors.

Outside of the United States, especially in countries with high savings rates, however, the endowment policy is still quite successful and widely used to accumulate funds for a variety of purposes. It is frequently purchased to fund retirement and sometimes to fund children's higher education.

It is interesting to note that endowment policies purchased in other countries are usually bought for the same reasons permanent life insurance policies are purchased in the United States. Regardless of the society or its tax laws, the primary factor motivating life insurance sales is an individual's concern about financial security for his or her children, spouse, parents, and/or business partners. The individual's particular needs tend to change in predictable ways over a normal life cycle.

**TABLE 3-1  
Corridor Test for Cash Value Life Insurance**

Age	Death Benefit Must Exceed Cash Value by This Multiple	Cash Value May Not Exceed This % of Death Benefit
0 to 40	2.50	0.40
41	2.43	0.41
42	2.36	0.42
43	2.29	0.44
44	2.22	0.45
45	2.15	0.47
46	2.09	0.48
47	2.03	0.49
48	1.97	0.51
49	1.91	0.52
50	1.85	0.54
51	1.78	0.56
52	1.71	0.58
53	1.64	0.61
54	1.57	0.64
55	1.50	0.67
56	1.46	0.68
57	1.42	0.70
58	1.38	0.72
59	1.34	0.75
60	1.30	0.77
61	1.28	0.78
62	1.26	0.79
63	1.24	0.81
64	1.22	0.82
65	1.20	0.83
66	1.19	0.84
67	1.18	0.85
68	1.17	0.85
69	1.16	0.86
70	1.15	0.87
71	1.13	0.88
72	1.11	0.90
73	1.09	0.92
74	1.07	0.93
75 to 90	1.05	0.95
91	1.04	0.96
92	1.03	0.97
93	1.02	0.98
94	1.01	0.99
95	1.00	1.00

Source: IRC Sec. 7702(d)(2)

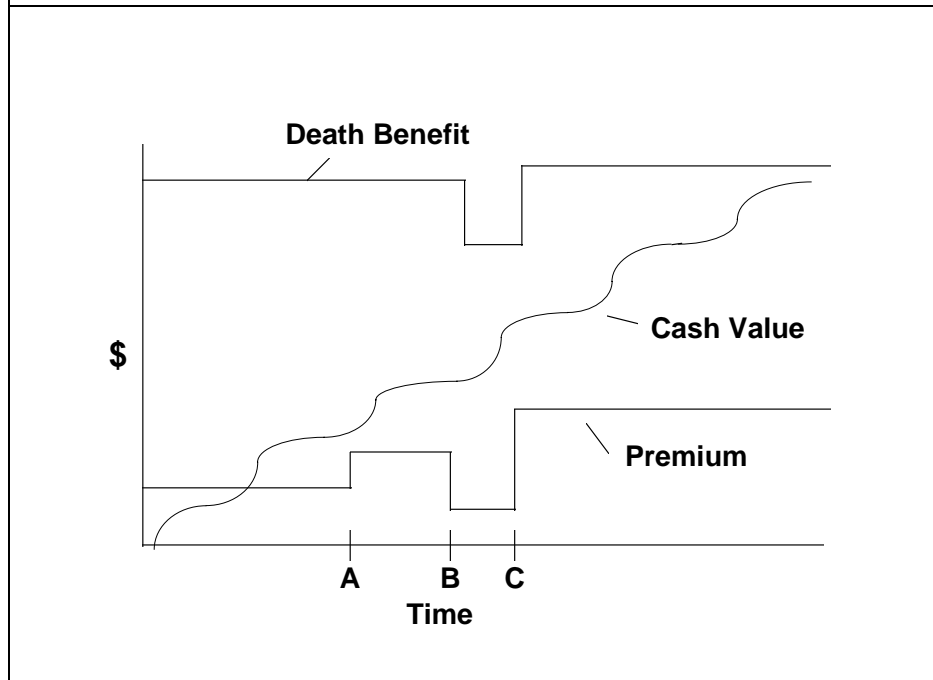
## Adjustable Life Insurance

Families changing needs for life insurance over long durations prompted some insurers to introduce whole life insurance that can be adjusted when needed to accommodate life cycle shifts. The *adjustable life policy*, which can be configured anywhere along the spectrum from short duration term insurance through single premium whole life insurance, gives the policyowner the right to request and obtain a reconfiguration of the policy at specified intervals. It appeals to purchasers who want the ability to restructure their coverage without assuming any of the investment or mortality risks.

One important aspect of adjustable life is that it is a whole life policy with fixed premiums. Although premiums can be changed, such a change requires a formal adjustment agreed to by both insurer and policyowner before it can be made. The premium remains fixed and inflexible between formal adjustments. Adjustable life insurance policies offer all of the same guarantees regarding cash values, mortality, and expenses as traditional whole life policies do. The elements subject to change are the premium, face amount, and cash value (see figure 3-3). Most changes can be made without evidence of insurability, but the insurer can require such evidence if the proposed change increases the amount at risk.

Events that frequently prompt policy adjustments include dependent children starting college, the self-sufficiency of the youngest child, loss of employment, the start or failure of a business venture, change of career, or retirement. Some adjustments involve lowering the premium level to lessen the cash flow burden and some involve increasing the premium as the policy owner's discretionary income improves.

**FIGURE 3-3**  
**Adjustable Life**  
**Policy Recast at Policyowner's Request at A, B, and C**



This type of policy was introduced in the mid-1970s and had gained modest success with a few insurers before the advent of universal life policies. Interest in adjustable life waned after the success of universal life in the 1980s. Some of the insurers that maintained adjustable life as part of their product line, however, found that it had renewed acceptability after universal life lost its predominant share of new product sales in the low-interest environment of the early 1990s.

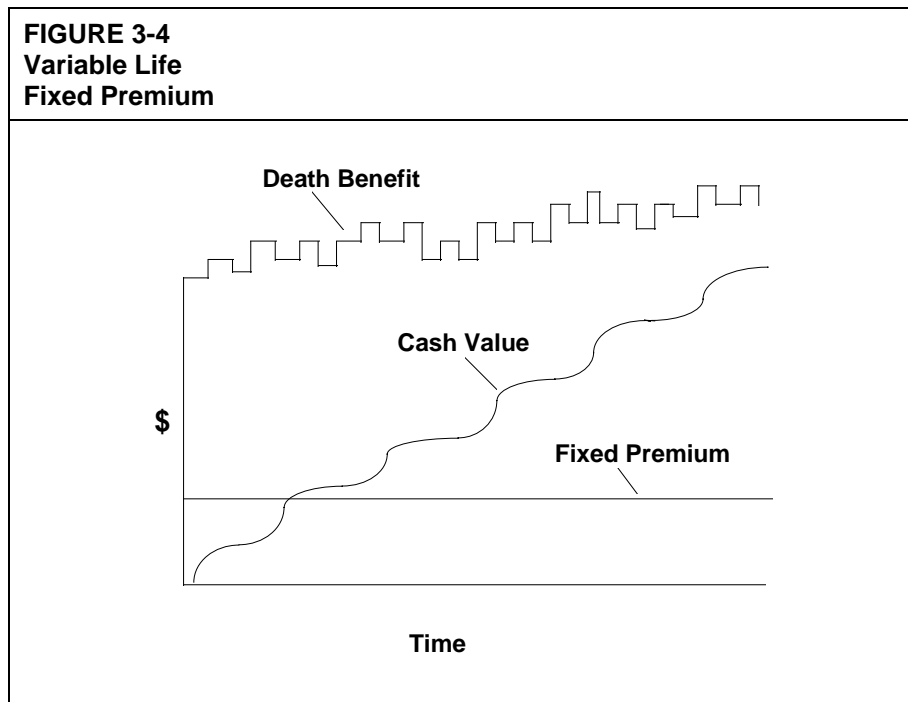
## Variable Life Insurance

Variable life insurance was the first life insurance policy designed to shift the investment risk to policyowners. A *variable life insurance* policy provides no guarantees of either interest rate or minimum cash value. Theoretically, the cash value can go down to zero, and if so, the policy will terminate. In order for policyowners to gain the additional benefit of better-than-expected investment returns, they also have to

assume all of the downside investment risk. Consequently, the SEC required variable life policies to be registered with the SEC and all sales to be subject to the requirements applicable to other registered securities. In other words, policy sales can be made only after the prospective purchaser has a chance to read the policy prospectus. The SEC also requires that the insurance company be registered as an investment company and that agents become registered representatives. Agents who sell variable life insurance policies must be licensed as both life insurance agents and securities agents.

### SEC Objections to Variable Life

The first generation of variable life insurance products were fixed-premium products (see figure 3-4). The only real innovation was the variable investment aspect—that is, the policyowner was permitted to select among a limited number of investment portfolio choices, with the death benefit amount varying as a function of the portfolio's investment performance.



## **Investment Choices**

Generally, the first generation of variable life insurance policies gave the purchaser three investment options into which the funds could be directed. There was usually a minimum requirement of at least 5 or 10 percent of incoming funds that had to be allocated to any investment option the policyowner selected. The purpose of this minimum requirement was to eliminate the possibility that administrative costs would exceed the amount of money being directed into a particular option.

Very often the options were a stock fund, a bond fund, and either a treasury fund or a money market fund. The funds were essentially mutual funds run by the insurance company and set aside as separate accounts (required by the SEC) that do not constitute part of the insurance company's general investment fund and put such assets beyond the claims of its general creditors.

Although the policyowner chooses among the offered funds, he or she has no control over the assets purchased and sold by the individual funds. That portion of the investment decision process is still within the hands of the insurance company's portfolio management team. However the policyowner plays a participative role in the selection of the investments that support the policy and consequently can benefit directly from better results or bear the brunt of poor investment performance. The results of the investment performance are credited directly to the policy cash values.

**Ability to Tolerate Risk**—Individuals who are already experienced in equity investments are quite comfortable with the variable life insurance policy. However, this policy is subject to daily portfolio fluctuations and can provoke great anxiety in individuals who are not used to or comfortable with such market value fluctuations.

A variable life policy is a market-driven phenomenon, and its popularity is influenced by general investment market conditions. The policy becomes more acceptable to consumers after a long period of market increases and falls out of favor when the market experiences a general decline in prices.

**Insurance Charges**—Variable life insurance contracts are not exclusively investments. They also sustain mortality charges for the death benefits they provide. Consequently, the pre-tax return on the invested funds within a variable life insurance contract will never equal

that of a separate investment fund that does not provide death benefits but invests in assets of a similar type and quality.

Variable life insurance should not be purchased as a short-term investment vehicle. Although investment performance in equities tends to equal or exceed inflation in the economy over the long term, the correlation is not perfect in the short term. It is possible for inflation to exceed increases in the investment performance for short durations of time. In addition, the combination of sales load, mortality charges, and surrender charges will significantly reduce any potential gains in the policy's early years.

### **Increased Number of Investment Fund Options**

Variable life insurance designs have not been static since their introduction in the mid-1970s. Life insurance companies are now offering many investment fund options. There are usually a variety of stock and bond funds. In addition, many insurance companies offer a managed fund as one of the portfolio choices. The policyowner can put all of the policy funds in a managed portfolio fund and have the investment allocation decisions made by a professional money manager working for the insurance company. This appeals to policyowners who do not want to spend a lot of time studying the market and making investment decisions. With a managed portfolio policyowners can reap all of the long-term advantages of a variable insurance contract without having to perform the investment allocation function themselves.

Some insurance companies have formed alliances with large mutual fund groups that make their entire range of mutual funds available. Such alliances make it possible for these life insurance companies to gain access to the administrative services already in place in these large mutual fund family groups.

### **Policy Cash Values**

Policy premiums paid under variable life insurance contracts are often subject to an administrative charge; the balance of the premium payment goes into the cash value account. The actual value of the cash component is determined by the net asset value of the separate account funds that make up the policy portfolio. The cash value of a variable life policy fluctuates daily. Each day's net asset value is based on the closing price for the issues in the portfolio on that trading day. Cash value accounts are further diminished by mortality charges to support the death benefits.

As with traditional life insurance contracts, the policyowner has access to the cash value via policy loans. The earnings on the cash value are obviously affected by any outstanding policy loans. The policyowner accrues indebtedness at the applicable policy loan interest rate, and that is the yield applicable to the assets associated with the portion of the cash value offset by the outstanding loan. Whenever the policy loan interest rate is lower than the portfolio investment earnings rate, the insurance company experiences a lower effective investment return. The only time the insurance company experiences a financial gain from policy loans is when the policy loan interest rate exceeds that earned by the portfolio backing the policies.

Policy loans can be repaid at any time in part or in full, but there is no requirement that policy loans be repaid in cash at any time during the existence of the life insurance contract. For any portion of the loan not repaid, interest accrues on a compound basis. Outstanding policy loans under a variable life insurance policy reduce the death benefit payable. The policy loan is always fully secured by the remaining cash value in the policy. Whenever the outstanding loans plus accrued interest equal the remaining cash value, the net cash value becomes zero and the policy terminates.

The net cash value in the contract is also closely related to the nonforfeiture options available under the policy. Variable life insurance contracts provide the same range of nonforfeiture options as do traditional whole life policies.

Variable life insurance policies also contain the usual form of reinstatement provisions, including a specific prohibition on reinstatements if the policy has been surrendered for its cash value.

Contracts also have the standard waiver-of-premium option since premiums are fixed and the policy will lapse if they are not paid.

**Primary Focus of Prospectus Disclosure**

- Operating expenses
- Marketing expenses
- Taxes and fees
- Cost of insurance charge
- Surrender charges
- Investment charges
- Investment performance

**The Prospectus**

Variable life insurance policies cannot be sold without an accompanying *prospectus*. The variable life prospectus mandated by the SEC is similar in many respects to the prospectus required of new stock issues. The prospectus provides thorough and accurate information to the prospective purchaser concerning the company issuing the life insurance contract as well as a full disclosure of all the provisions of the contract, including

expenses, investment options, benefit provisions, past performance of the investment options, and policyowner rights under that contract. It is a lengthy and detailed document.

**Expense Information**—The prospectus explains all of the expense charges levied by the insurance company against variable life insurance contracts. This includes commissions paid to soliciting agents, state premium taxes, administrative charges, collection charges, and possibly fees for specific future transactions. The prospectus also indicates whether or not there is any maximum guarantee on those administrative fees over the duration of the contract.

In addition, the prospectus sets forth the manner in which charges are made against the asset account to cover the cost of insurance under the contract. The prospectus specifies what rate will be used to determine *cost-of-insurance* charges and if there is any maximum rate above the intended rate. It also explains the manner in which charges are levied against the separate account itself; these are the fees associated with managing the various types of mutual fund accounts from which the policyowner can choose.

**Surrender Charges**—The charges applicable to policy surrenders are usually set forth in a tabular form, giving the policy year and the applicable percentage for the surrender charge in that year. Surrender charges are commonly levied during the first 10 to 15 years of the contract. The actual number of years and specific rates are always set forth in the prospectus.

**Investment Portfolio Information**—The prospectus sets forth the investment objectives of each of the available investment funds and a record of their historical performance. It includes detailed information on the current holdings of each of the available portfolios, usually supplemented by information about purchases and sales of individual equities or debt instruments by the fund over the previous 12 months. Further information is given about earnings during that same period of time, and usually for longer intervals of prior performance if those portfolio funds have been in existence long enough to give investment results for trades over 5 or 10 years. Any investment restrictions applicable to these portfolios are fully disclosed.

There are also projections of future performance under the contract if portfolio funds generate a fixed level of investment earnings over the

projected interval. Under SEC regulations the permissible rates of return that can be projected are the gross annual rates after tax charges but before any other deductions at 0, 4, 6, 8, 10, or 12 percent. The insurance company can decide which of those permissible rates it chooses to project.

### **Risks the Policyowner Assumes**

Fixed-premium variable life insurance contracts are very similar to whole life insurance contracts, except that the policyowner assumes the investment risk. The fixed-premium provision does not allow the policyowner to increase or decrease the death benefit by negotiated adjustment. Favorable results automatically translate into increased death benefit amounts.

One unique benefit of a variable life policy is that it does guarantee a minimum death benefit equal to the original face amount of the contract, regardless of how badly the investment performance turns out to be. If all of the required premiums are paid, the insurance company guarantees that the death benefit equal to the original face amount of the policy will be paid even if the investment funds are otherwise inadequate to support the policy. Therefore, the variable feature of this contract can provide additional coverage if investment experience warrants, but the policyowner will never be required to pay more or permitted to pay less than the guaranteed premium.

A fixed-premium variable life insurance policy provides more guarantees to the policyowner than universal life and variable universal life.

## **Variable Adjustable Life Insurance**

Variable adjustable life is a policy that can be negotiated to change the death benefit level up or down, or to increase or decrease premium amounts to a new fixed level (which can shorten or lengthen the premium-paying period). It also offers the policyowner the ability to choose the investment portfolio, within limits. This contract overcomes one of the shortcomings of the fixed-premium variable life contract by allowing the policyowner to negotiate with the insurance company a changed policy configuration that more closely fits the policyowner's changed circumstances.

The policyowner does not have the unilateral right to skip premium payments or vary the amount of any premium payment at will without prior negotiation with the insurance company. As with the first generation of variable life insurance contracts, the death benefit is tied to investment performance but guaranteed never to be less than the original amount of coverage under the policy.

Most of the insurance companies offering variable adjustable life coverage chose not to enter the universal life market. In fact, they introduced *variable adjustable life insurance* as a defensive move to compete with universal life, after the marketing success of its flexible-premium design.

## Universal Life Insurance

*Universal life insurance* was introduced in 1979 as a revolutionary new product. It was the first variation of whole life insurance to offer truly flexible premiums. It also included adjustment provisions similar to those contained in the adjustable life contract. These policies shifted some of the investment risk to the policyowner because the premium was based on interest rates in excess of the guaranteed interest rate, but they did not give the policyowner any option to direct the investment portfolio. Two other features initiated with universal life policies are: (1) the policyowner's ability to withdraw part of the cash value without having the withdrawal treated as a policy loan and (2) the choice of either a level death benefit design or an increasing death benefit design.

### Flexible Premiums

The true innovation of universal life insurance was the introduction of completely flexible premiums after the first policy year, the only time a minimum level of premium payments for a universal life policy is rigidly required. As usual, the first year's premium can be arranged on a monthly, quarterly, semiannual, or annual basis. The insurance company requires only that a minimum specified level of first-year premium payments be equaled or exceeded. After the first policy year, it is completely up to the policyowner as to how much premium to pay and even whether or not to pay premiums.

Nevertheless, the aggregate premiums paid, regardless of their timing, must be adequate to cover the costs of maintaining the policy. If the policy cash value is allowed to drop too low (for example, the cash

value is inadequate to cover the next 60 days of expense and mortality charges), the policy will lapse. If an additional premium payment is made soon enough, the policy may be restarted without a formal reinstatement process. However, if an injection of additional funds comes after the end of the grace period, the insurance company may force the policyowner to request a formal reinstatement before accepting any further premium payments.

## **Prefunding**

Prefunding a universal life policy means putting more money into the policy than is currently needed to cover the costs of keeping the policy in force. The higher the amount or proportion of prefunding, the more investment earnings will be utilized to cover policy expenses. This brings us to the legendary adage that there are two sources of money: people at work and money at work. By putting money into the policy early, the money starts earning money and therefore reduces the amount of premium payments needed from people at work at later policy durations. The ultimate extreme of prefunding is the single premium approach, where an adequate fund is created at the inception of the policy to cover all future costs. The more common approach is a level-premium structure in which partial prefunding creates an ever-increasing cash value that in turn generates increasing investment returns to offset mortality and administrative costs.

All premium suggestions are based on some assumed level of investment earnings and the policyowner bears the risk that actual investment earnings will be less than that necessary to support the suggested premium. Even though investment earnings cannot go below the guaranteed rate, a long-term shortfall may necessitate either an increase in premiums or a reduction in coverage at some future point.

At the other end of the spectrum is the minimum-premium approach, which is virtually synonymous with annual renewal term insurance. There is minimal, if any, prefunding, and premium payments barely cover the current mortality and expense charges. Under this approach the premiums must increase as the insured ages since mortality rates increase with the age of the insured. Premiums increase rapidly at advanced ages because there is still a maximum amount at risk (the cash value is very low, and the mortality rate must be applied to nearly the full death benefit amount). Under the partial prefunding approach, however, cash value increases make the amount at risk decrease (amount at risk equals

the policy's face amount minus its cash value) as the insured ages, and the increasing mortality rate is applied to a smaller at-risk amount.

Under traditional whole life insurance policies insurance companies designed a wide range of level premium contracts, each with a different level of fixed premiums. Contracts with a higher level premium tended to develop larger cash values at earlier policy durations. Once the policy cash value was adequate to prefund the policy totally, the policy could be converted to a guaranteed paid-up status. Under participating designs, dividends could exceed the premiums after the policy had developed a large enough cash value to prefund all future policy elements.

Under the traditional contracts with cash values, the only mechanism for returning any policy overfunding in the early years was policyowner dividends. With universal life policies, however, the accumulations from prefunding are credited to the policy's cash value and are quite visible to the policyowner. The earnings rates applied to those accumulations are also clearly visible as they fluctuate with current economic conditions.

### **Withdrawal Feature**

Another new feature introduced with universal life policies is the policyowner's ability to make partial withdrawals from the policy's cash value without incurring any debt. Money can be taken out of the universal life policy cash value just like a withdrawal from a savings account, and there is no obligation to repay those funds; nor is there any incurring interest on the amount withdrawn. Withdrawals do affect the policy's future earnings because the policy's cash value (which is the source of future earnings) is reduced by the amount of the withdrawal. Its effect on the death benefit depends on the type of death benefit in force.

### **Target Premium Amount**

Nearly every universal life policy is issued with a target premium amount. The *target premium* amount is the suggested premium to be paid on a level basis throughout the contract's duration. This amount is merely a suggestion and carries no liability if it is inadequate to maintain the contract to any duration, much less to the end of life.

In some insurance companies that target premium is actually sufficient to keep the policy in force (under relatively conservative investment return assumptions) through age 95 or 100 and to pay the cash value equivalent to the death benefit amount if the insured survives to either age 95 or 100. On the other hand, some companies with a more aggressive marketing stance have chosen lower target premiums, which

are not adequate to carry the policy in force to advanced ages, even under more generous assumptions of higher investment returns over future policy years.

If the actual investment return credited to the policy cash value falls short of the amounts assumed in deriving the target premium, the policyowner will be faced with two options: (1) to increase the premium level or (2) to reduce the death benefit amount.

Some insurance companies have introduced a secondary guarantee associated with their target premium. These companies have pledged contractually to keep the policy in force for, say, 15 or 20 years and to pay the full death benefit as long as the premium has been paid in an amount equal to or greater than the target premium amount at each suggested premium-payment interval. Even these guarantees do not extend to age 95 or 100, but they are at least a guarantee that the premium suggested as a target will be adequate to provide the coverage at least as long as the guarantee period. Probably the best indication of whether or not the target premium is adequate to keep the policy in force up through age 95 or 100 is to compare it with premiums for a traditional whole life policy of a similar face amount and issue age. Universal life policy target premiums less than premiums for a comparable whole life policy should be suspect; they may be intentionally low by design because the insurance company does not expect the policy to remain in force until the very end of life in the majority of cases. The only people who will ever really find out whether or not their policy target premiums are adequate are those who pay the premiums religiously throughout the duration of the contract and live to be an age that is old enough to test the target premium.

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**Example:** Bert is now 70 years old. He has paid the target premium on his universal life policy for the last 15 years. He was not told, and he did not realize, that the target premium was only intended to keep coverage in force to age 65. Bert wants to keep his coverage, but the target premium he is paying is not adequate to support it. He will have to increase premium payments by more than 20 percent to keep the same amount of coverage, or else he will have to reduce the amount of coverage to a level where the target premium is adequate to support the reduced coverage.

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**Additional Premium Payments**—The flexible features of universal life premiums allow policyowners to make additional premium payments above any target premium amount at any time the policyowner desires without prior negotiation or agreement with the insurance company. The only limitation on paying excess premiums is associated with the income tax definition of life insurance (IRC SEC. 7702). However, the insurance company reserves the right to refuse additional premium payments under a universal life policy if the policy's cash value is large enough to encroach upon the upper limit for cash values relative to the level of death benefit granted in the policy.

### **Death Benefit Type**

Universal life insurance gives policyowners a choice between level death benefits and increasing death benefits. The level death benefit design is much like the traditional whole life design (see figures 3-5 and 3-6). When the death benefit stays constant and the cash value increases over the duration of the contract, the amount at risk or the protection element decreases.

The one new aspect of a level death benefit designed under universal life policies is not really a function of universal life itself but a function of a tax law definition of life insurance that was added to the Code shortly after the introduction of universal life insurance policies, requiring that a specified proportion of the death benefit is derived from the amount at risk. This is IRC Sec. 7702 referred to earlier in this chapter. Whenever the cash value in the contract gets high enough that this proportion is no longer satisfied, the universal life policy starts

increasing the death benefit (corridor test) even though the contract is called a level death benefit contract. This phenomenon typically does not occur until ages beyond normal retirement, and it is not a significant aspect of this design.

The increasing death benefit design is a modification that was introduced with universal life policies (see figures 3-7 and 3-8). Under this approach there is always a constant amount at risk that is superimposed over the policy's cash value, whatever it may be. As the cash value increases, so does the total death benefit payable under the contract. A reduction in the cash value will reduce the death benefit. This

#### **Death Benefit Type Mortality Charges**

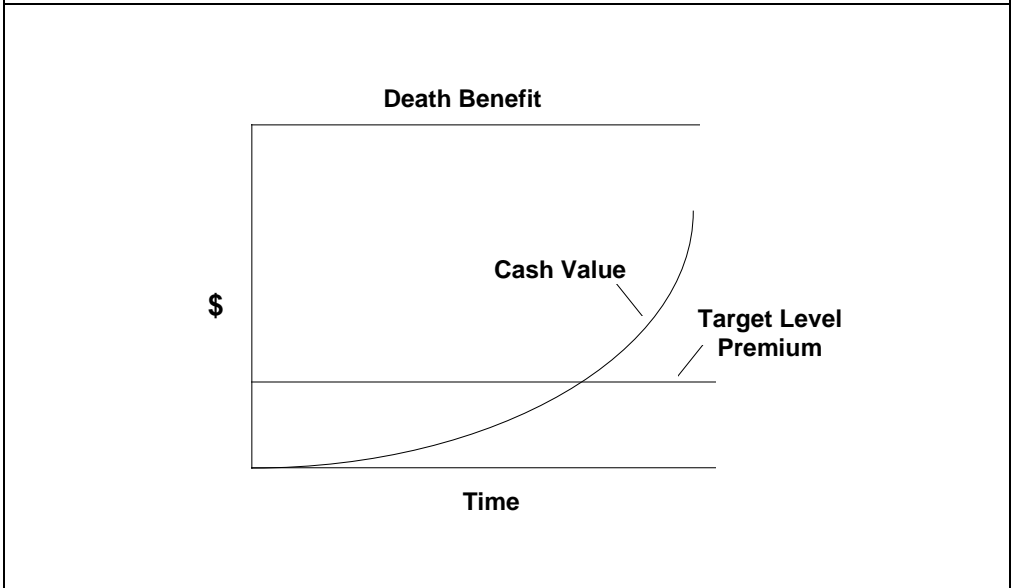
- Mortality charges for level death benefit type apply to a decreasing amount at risk.
- Mortality charges for increasing death benefit type apply to a constant amount at risk.

design pays both the policy's stated face amount and its cash value as benefits at the insured's death. Policies with an increasing death benefit design overcome the criticism of whole life policies that the death benefit is partially made up of the contract's cash value portion. By selecting the increasing death benefit option under a universal life policy the policyowner is ensuring that the death benefit will be composed of the cash value and an at-risk portion equal to the original face value of the contract.

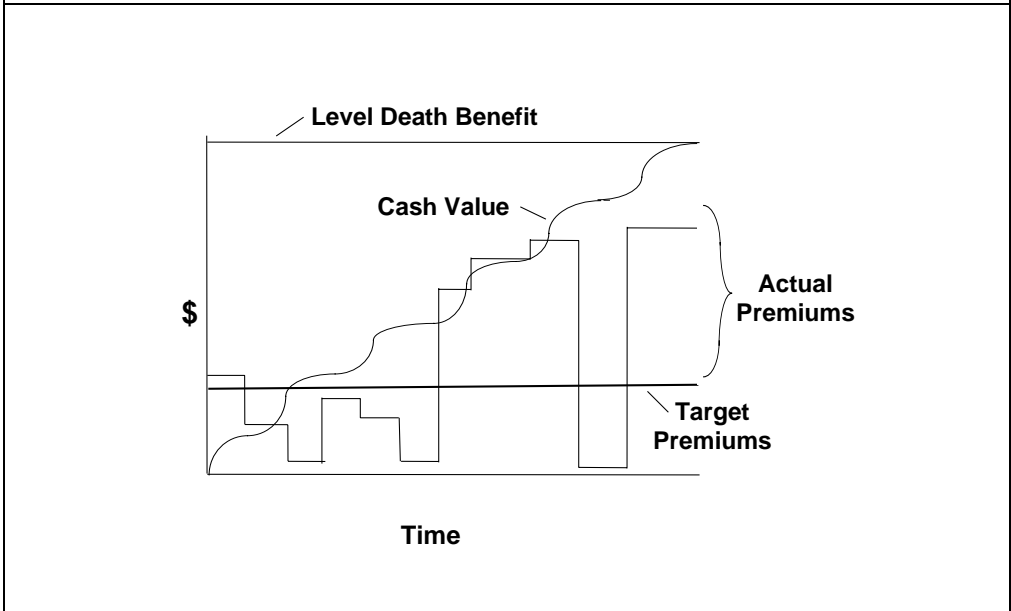
There is nothing magical about this larger death benefit amount. As is often said, there is no free lunch. A higher portion of the premium is needed for the larger amount at risk under this design.

There are similarities between the increasing death benefit design for universal life and the paid-up additions option under a participating whole life policy. Under a whole life policy, dividends are used to purchase single-premium additions to the base policy. In both types of policies the excess investment earnings are used to increase the cash value and the death benefit.

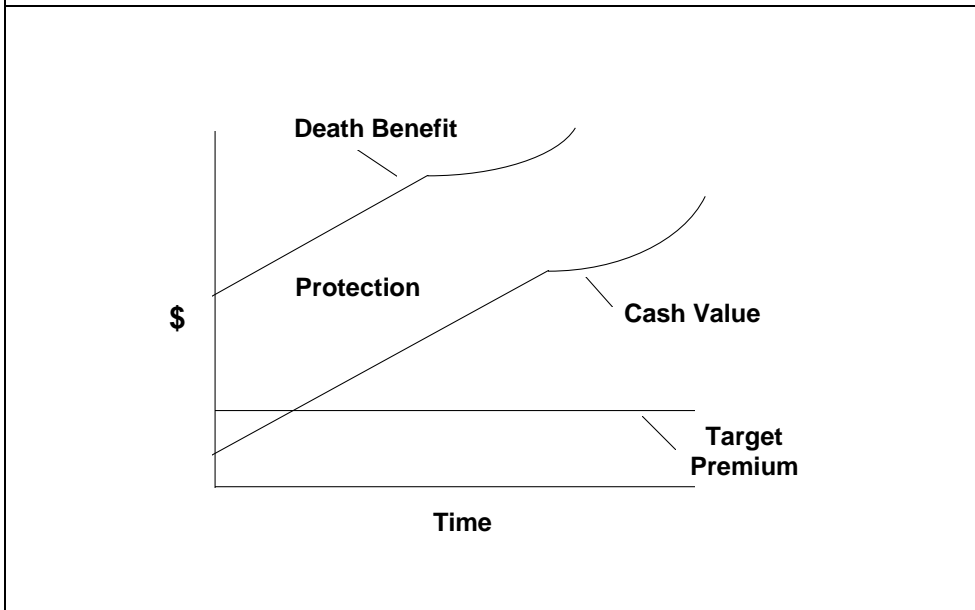
**FIGURE 3-5**  
**Universal Life Type I, Type A, etc.**  
**Level Death Benefit (If Target Premium Is Always Paid)**



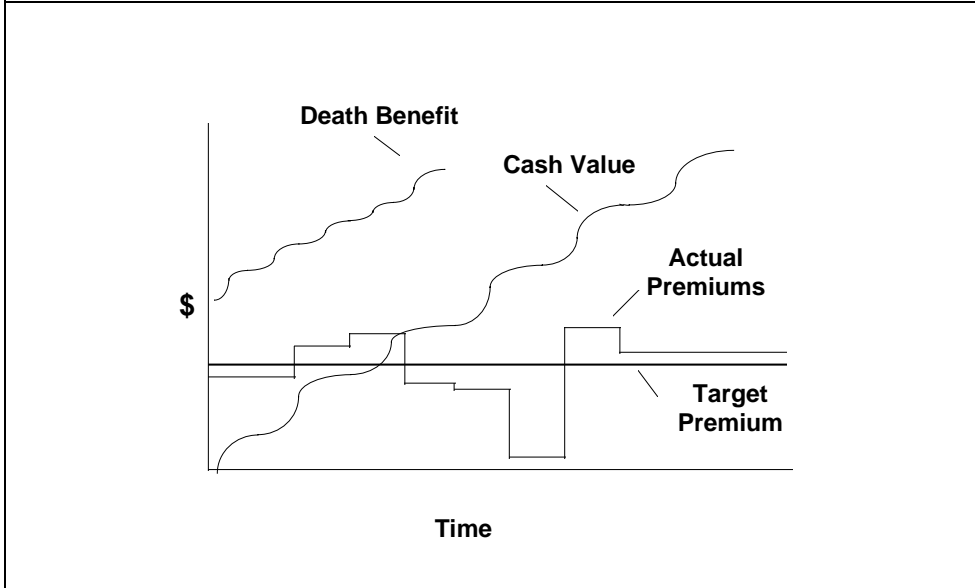
**FIGURE 3-6**  
**Universal Life Type I, Type A, etc.**  
**Level Death Benefit (but Premium Payment Waived)**



**FIGURE 3-7**  
**Universal Life Type II, Type B, etc.**  
**Target Premium Paid**



**FIGURE 3-8**  
**Universal Life Type II, Type B, etc.**  
**(Uneven Premium Paid) Death Benefit = Level Amount at Risk + Cash Value**



Because the mechanics of the two death benefit designs and the universal life policies are slightly different, the effect of partial withdrawals on the death benefit amount differs. Partial withdrawals do not reduce the death benefit amount under the level death benefit design. They do, however, decrease the amount of the policy's cash value and correspondingly increase the amount at risk. As a result, the mortality charge will increase after the partial withdrawal to pay the mortality risk applicable to the greater amount at risk.

Partial withdrawals under the increasing death benefit design will in fact reduce the death benefit payable because the withdrawal decreases the cash value that constitutes part of the death benefit amount. However, such withdrawals will not reduce the mortality charges for the amount at risk because that at-risk amount remains constant. Reducing the cash value by the amount of the partial withdrawal does, however, have a negative impact on the amount of investment earnings credited to the cash value.

### **Effect of Policy Loans**

Another aspect of policy design ushered in with universal life policies is the differential crediting rate on the cash value, depending on whether there are policy loans outstanding. Most universal life policies credit current interest rates on the cash value as long as there are no outstanding policy loans. Once the policyowner borrows funds from the cash value, the insurance company usually credits a lower interest rate or earnings rate to the portion of the cash value associated with the policy loan. This is another effort to curb disintermediation.

Outstanding policy loans at the time the insured dies will reduce the death benefit by the amount of the loan plus any unpaid interest on the loan. This is the same for universal life policies as it is for any life insurance policy that has policy loans.

Universal life policies sold today generally credit the cash value with the current rate for nonborrowed funds and a lower rate, which is often 2 percent (200 basis points) lower than the current rate, for borrowed funds.

### **Internal Funds Flow**

Although universal life insurance policies are still relatively young in the overall realm of life insurance products, some policies are already in their fifth or sixth generation of policy series from the company that introduced them. As with all products, the individual policy designs

constantly evolve in response to the economy, competitive pressures, tax code changes and innovative zeal. Most of the first generation of universal life policies were heavily front-end-loaded products. They took a significant proportion of each premium dollar as administrative expenses, and the remaining portion was then credited to the policy cash value account.

After the funds had reached the policy cash value account, they were subject to charges for current death benefits in the form of a mortality charge based on the amount at risk. In most insurance companies the mortality rate actually charged was often in the neighborhood of 50 percent of the guaranteed maximum mortality rate set forth in the policy contract for each attained age of the insured. The difference in the mortality rate actually being charged and the maximum permitted mortality rate published in the policy represents the safety margin the life insurance company is holding in reserve. If the future mortality costs for the block of policies turn out to be more expensive than initially assumed, the insurance company can increase the mortality rate as long as it does not exceed guaranteed maximum rates specified in the contract itself.

After deductions for expenses and mortality, the universal life cash value account is then increased at the current crediting rate to reflect investment earnings on that cash value. These are the dollars at work for the policyowner to help reduce his or her current and future out-of-pocket premium expenses. The actual rate credited is a discretionary decision on the part of the insurance company, and it tends to fluctuate freely, reflecting current economic conditions.

There have been times when some insurers were reluctant to credit the current interest rate to the policy's cash value. As interest rates were dropping gradually and steadily over the last decade, many insurance companies were hesitant to allow their current interest crediting rate to drop below 10 percent, and interest crediting rates seemed to stick around that point. Eventually, the economic folly of crediting interest rates in excess of actual earnings on the invested assets became apparent, and single-digit interest rates replaced double-digit rates in the crediting formula.

Interest crediting rates have been the focal point of most of the competition among companies selling universal life policies. There has been very little emphasis on the mortality rates charged or the expense charges levied against incoming premiums. In reality all three concepts constitute the total cost of insurance. Interest rates can be (and have

been) intentionally elevated to a level above what the investment portfolio actually supported, but they are still viable because of compensating higher levels of mortality charges and expense deductions. When consumers choose to focus only on one of the three elements, it is not surprising that the marketing efforts zero in on that element. The assessment of overall policy efficiency requires that all factors be considered in concert.

As the universal life insurance policies evolved, more of them moved to a back-end loading design. In other words, they lowered or eliminated the up-front charge levied against incoming premium amounts and instead imposed new or increased surrender charges applicable to the cash value of a policy surrendered during the contract's first 7 to 15 years. Surrender charges are usually highest during the first policy year and decrease on a straight-line basis over the remaining years until the year in which the insurance company expects to have amortized all excess first-year expenses. At that point the surrender charge is reduced to zero and will not be applicable at later policy durations. The actual surrender charge itself can be based on either the cash value amount or on the target premium level. Some insurers have developed a hybrid that depends on both approaches to generate the full surrender charge. The surrender charge usually decreases by the same percentage on each policy anniversary until the applicable charge reaches zero. The net amount payable for a surrendered policy is determined by deducting any applicable surrender charge from the policy cash value minus any unpaid policy loans and interest.

Companies with the highest surrender charges tend to have little or no front-end expenses charged against premiums. Some companies have policies that combine moderate front-end loading and moderate surrender charges. There seems to be a discernible preference for higher surrender charges and little or no front-end loading in most universal life policies being marketed today.

The actual component of the front-end loading can be a flat annual charge per policy plus a small percentage of premium dollars actually received, and a charge of a few cents per each \$1,000 of coverage in force under the policy. The charges applicable to the premiums and the amount of coverage are usually deducted monthly from the policy cash value account. Similarly, the current interest crediting rate is also usually applied monthly. These are the deposits and withdrawals from our gas tank.

Some companies have actually eliminated charges based on the amount of coverage in force. Competitive pressures have also caused many insurance companies to minimize front-end loading in order to emphasize that nearly all premium dollars go directly into the cash value account. The actual expenses are still being exacted internally, but the manner in which they are handled is not easily discernible by the consuming public. For example, expenses can be embedded in the spread between actual mortality costs and actual mortality charges or in the spread between investment earnings and the interest rate credited to the cash value accounts.

It is important to realize that no insurance company is able to operate without generating legitimate costs of operations above the amount needed to pay death benefits only. These expenses must be covered somehow, and the method of allocating them is nothing more or less than a cost-accounting approach. The exact allocation formula is always arbitrary and to some extent guided by the philosophy of the insurance company management team. It must address such issues as equity among short-term and long-term policyowners, the appropriate duration for amortizing excess first-year expenses, and how much investment and operations gains to retain for company growth and safety margins and how much to distribute to policyowners.

### **Flexibility to Last a Lifetime**

The astonishing flexibility of premiums under universal life policies and the ability to adjust death benefits upward and downward have created life insurance policies that can literally keep pace with the policyowner's needs. The policy can be aggressively funded when the premium dollars are available, and premium payments can be intentionally suspended during tight budget periods, such as the formation of a new business or while children are attending college. The policy death benefit can be increased (sometimes requiring evidence of insurability) if the need exists, and after any temporary needs have expired the policy can be adjusted downward to provide lower death benefits if that is what the policyowner wants. The ability of a universal life contract to fit constantly changing policyowner needs and conditions has led some companies to label this coverage irreplaceable life insurance. Some see it as the only policy ever needed because its versatility will allow it to compensate for any necessary changes.

Probably the most serious drawback to universal life policies is the competitive forces insurance marketers use to try to convince the

prospect that their own version of universal life is better than anyone else's. In reality all universal life policies are similar, and only future investment performance will really determine which one turns out to be slightly more efficient than its competitors. Consumers will be better off seeking a policy that does well over the long haul than looking for a policy that wins every short-term contest, because no policy can be best in all facets at every duration. Sometimes focusing on a single competitive advantage prompts insurance companies to make short-term adjustments that are not necessarily in their own or the policyowner's best interest in the long-term scenario.

## **Current Assumption Whole Life**

*Current assumption whole life* is a variation of traditional whole life that lies somewhere between adjustable life and universal life. Its cash value development is more like that of universal life than any other policy. It has a redetermination feature that essentially recasts the premium amount, and in some instances the death benefit, in reaction to the most recent interval of experience. That interval varies from one company to another but is frequently 5 years, although it can be as short as 2 years or as long as 7 years. The main feature that differentiates current assumption whole life from universal life is the absence of total premium flexibility in the renewal years (see figure 3-9).

Current assumption whole life is sometimes described as universal life with fixed premiums. This is an oversimplification because premiums can and will be restructured at specified policy anniversary dates. However, the analogy is probably useful in getting a mental image of this type of policy and how it differs from the traditional whole life policy, the adjustable life policy, and the universal life policy. It is just another example of refinements in policy design that fill in some of the missing points along a continuum of possibilities between both extremes—all fixed components and guarantees at one end and all flexible and nonguaranteed components at the other.

There are still quite a few guaranteed elements in current assumption whole life policies. There is a guaranteed death benefit and a minimum guaranteed interest rate to be credited on policy cash values. Some companies guarantee the mortality charge and the expense charges. When mortality and expense charges are guaranteed, the policy is often referred to as an *interest-sensitive whole life* policy because excess

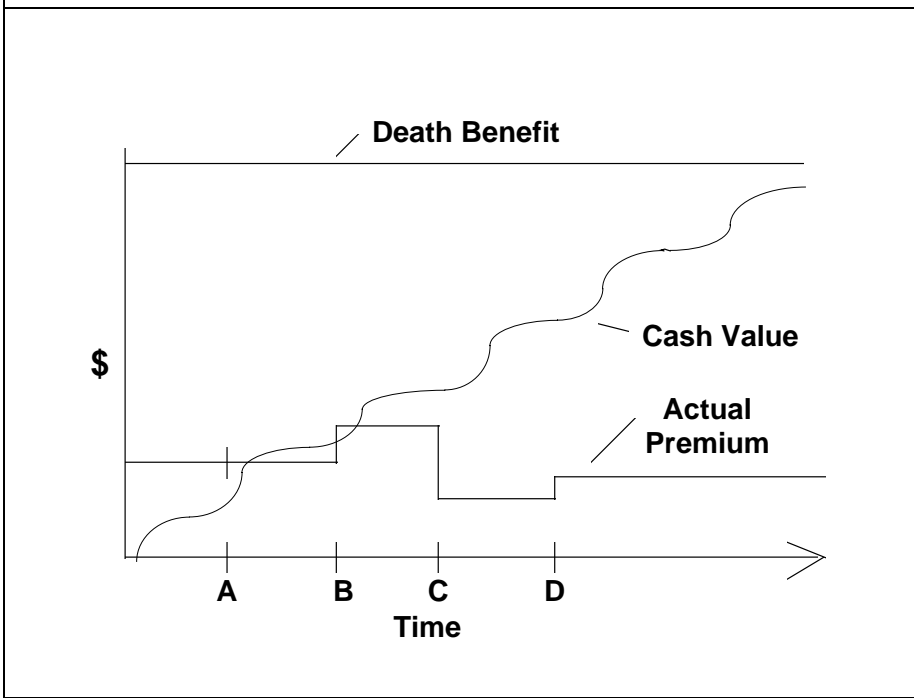
interest (credited interest minus guaranteed interest) credited to the cash value becomes the only nonguaranteed element in the contract. However, the bulk of the current assumption whole life policies have some degree of flexibility in the expense elements. Because many of these designs periodically recast the premium amount based on recognition of the most recent interval of experience, some of these policies are referred to as *indeterminate premium whole life* policies. The idea is that there is a guaranteed maximum possible premium that could be charged, but the actual mortality, interest, and expenses give rise to lower premium amounts actually being assessed as a result of favorable experience under the policy.

Current assumption whole life policies are nonparticipating policies that have some after-the-fact adjustment mechanisms without actually creating explicit policyowner cash dividends. These adjustment mechanisms allow the insurer to constantly fine-tune its policy and keep it competitive in the marketplace, based on actual company experience underlying the particular blocks of policies. From a company standpoint one of the big advantages of this policy design is its ability to eliminate the need for any deficiency reserve for the block of policies. Policy reserves can be calculated on the basis of the maximum chargeable premium and the minimum interest rate guarantee. Reserves will always be based on these factors, even though the premiums actually collected are lower than the premium assumption underlying the reserve and, more importantly, are less than the guideline premium for reserve valuation.

For competitive purposes in the marketplace, current assumption whole life gives the insurance company a product with a mechanism for sharing favorable investment returns with policyowners. These policies take away the advantage that participating whole life policies had over nonparticipating whole life policies. They are not so rigid that a change in market conditions automatically renders them obsolete, as was the unfortunate case with nonparticipating whole life policies before 1980.

Most current assumption whole life policies base their maximum possible mortality rate on 1980 Commissioners Standard Ordinary (CSO) Table rates. Because most insurance companies experience mortality significantly less costly than indicated by the CSO rates, the differential provides a very large safety margin for the insurer if it is later necessary to increase mortality rates and possibly even increase premiums on policy anniversaries when redetermination occurs.

**FIGURE 3-9**  
**Current Assumption Whole Life Type I or A**  
**Premiums Changed at Policy Redetermination Anniversary Date**



### Cash Value Illustrations

There are some variations in the way insurance companies approach the illustration of current assumption whole life policies. Nevertheless, it is possible to classify these variations into two basic categories.

The first basic category has a guaranteed cash value column and a separate column for excess accumulations (or some other descriptive title indicating that these values supplement the guaranteed cash value amounts). The total cash value for the policy is the sum of the guaranteed cash value and the accumulation supplements. The most complete representation tends to have three different columns for cash values—one for the guaranteed amount, one for the excess accumulations, and one representing the total of the two components. Any insurance company has wide discretion in how it depicts this approach in its illustrations. For example, illustrations often depict only the total cash value column and may or may not explicitly indicate that the cash value depends on projections of nonguaranteed amounts.

The second basic category merely has a single column titled “Enhanced Cash Value” (or an equivalent thereof). There is rarely any inclusion of the guaranteed cash value amount. This approach makes the policy look more like the cash value accumulation account reported under most universal life policies: premiums are shown as an incoming item that is reduced by expense charges before being added to the cash value account. Interest on the account balance is usually credited before any mortality charges are deducted. After mortality charges are deducted, the end-of-year fund balance is derived. The significant difference between the accumulation accounts in current assumption whole life and universal life is that universal life policies tend to charge off both expenses and mortality before crediting investment earnings. Current assumption whole life policies tend to deduct expenses from premiums but then credit that amount to the cash value and reflect a credit for investment earnings before deducting a mortality charge.

This approach has led many people to describe current assumption whole life as a hybrid of universal life and traditional whole life because it has cash value accumulations of excess interest crediting but still maintains a rigid level premium structure that can be changed on redetermination anniversaries.

### **Low Premium/High Premium Designs**

The proportion of excess accumulations under these policy designs is highly dependent on the premium level in the base design.

Some insurance companies use a relatively low-premium current assumption whole life design. Adjustments on redetermination dates are more likely to involve an adjustment of the death benefit to make the policy compatible with the premium level being paid. However, sometimes adjustments are to the premium (up or down), which may or may not change the death benefit.

At the other end of the spectrum some insurers utilize a high-premium design of current assumption whole life, where the premium paid is usually more than adequate and normally does not require an upward adjustment on a redetermination date. The high-premium design is more likely to involve projections of how long premiums may be needed until the policy is expected to be self-supporting without further contributions from the policyowner. It is a form of misnamed vanishing premium design.

The caution, however, is that excess accumulations are not guaranteed; nor is the projected period of premium payments guaranteed

to make the policy fully paid up at the end of that period. The policy will be paid up only if the future experience under the policy from that date forward is such that the interest credited and the accumulated account generate enough funds to meet all mortality charges and expenses over the entire remainder of the contract. There are no guarantees that this accumulation account might not have to be supplemented at some point if mortality charges and expenses cost more than the accumulation account can provide.

On the optimistic side, the policy could continue to exceed expectations even after it reaches paid-up status. If the investment returns on the accumulated fund keep the balance in that account more than adequate to pay all mortality charges and expenses, the policy could continue to enhance the benefits on each redetermination date. This would most likely involve an increase in death benefits since there are no further premiums to reduce at that point.

### **Redetermination**

The level of premiums influences the frequency of *redetermination*. The lower the premium design, the more frequent the policy's redetermination dates. In some of the more recent policy designs redetermination can be every year; more often the redetermination frequency is every 2 years or every 5 years. On policy anniversaries when it is applicable, the insurance company looks at its actual experience for the block of policies since the previous redetermination date and decides what adjustments, if any, are necessary, based on the assumption that past experiences are indicative of what to expect in the period before the next redetermination.

**Policyowner Options**—The policyowner generally selects the method he or she prefers to adjust the policy from an available group of options when redetermination occurs. For example, if the redetermination results in a potentially lower premium, the policyowner usually has the option of continuing the past level of premiums and having the favorable results applied to enhance the policy's cash value or increase the death benefit (assuming the insured can provide satisfactory evidence of insurability), or the policyowner may choose to pay the lower policy premium amount.

When past experience is less favorable than expectations, the policyowner again has a range of options, including lowering the death benefit, increasing the premium amount, or maintaining the status quo and allowing the policy accumulation account to decrease as the

mortality and expense charges exceed the investment earnings on the accumulated fund. This last choice, if available, may have restrictions on its use.

### **Uses of Current Assumption Whole Life**

In a current assumption whole life policy current interest rates are used to enhance the accumulation account, but the policy does not provide the premium flexibility of a universal life policy. Current assumption whole life is an appropriate policy choice for individuals who need the discipline imposed by its fixed-premium design but want to participate at least in part in the positive investment returns beyond the guaranteed interest rate in the policy. Under this type of policy, the policyowner assumes some of the investment risk and a limited portion of the mortality risk. If actual experience turns out to be poor, the policy may be periodically downgraded on each redetermination date. If actual experience is positive, the policyowner participates in the upside as the quid pro quo for assuming those risks or a portion thereof. Costs in the long run may turn out to be much less than the original projections if experience is favorable enough over the duration of the contract. The real challenge with this and many other life insurance products in which policyowners assume some of the risk is to make sure policyowners understand the nature and extent of the risk being assumed.

### **Variable Universal Life**

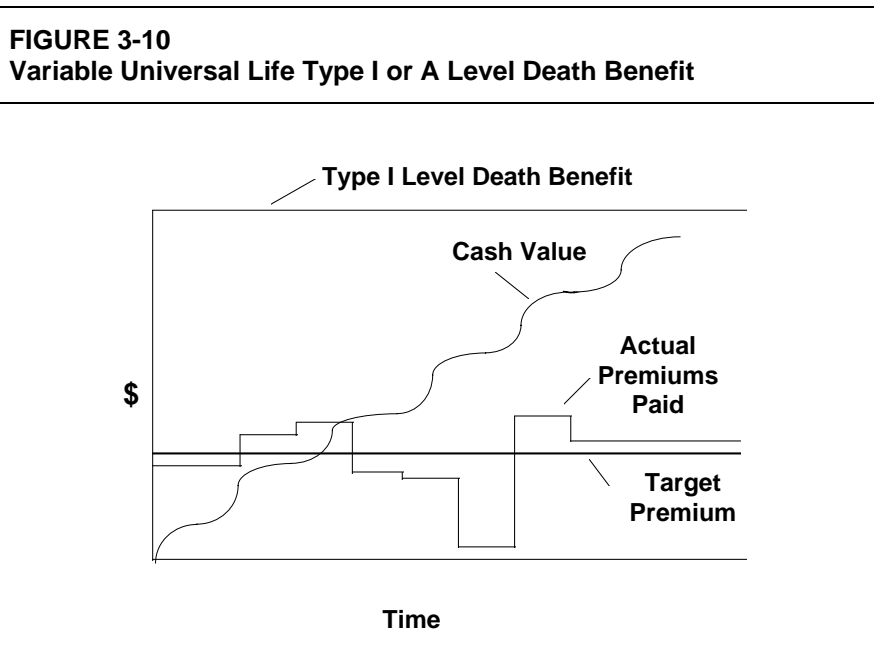
Variable universal life insurance incorporates all of the premium flexibility and policy adjustment features of the universal life policy with the policyowner-directed investment aspects of variable life insurance. Obviously this design discards the fixed-premium features of the variable life insurance contract (see Figures 3-10 and 3-11).

One of the most interesting aspects of *variable universal life insurance* is that it eliminates the direct connection between investment performance above or below some stated target level and the corresponding formula-directed adjustment in death benefits. Instead variable universal life insurance adopts the death benefit designs applicable to universal life policies, namely, either a level death benefit or an increasing death benefit design where a constant amount of risk is paid in addition to the cash accumulation account. Under the first of those options, the death benefit doesn't change, regardless of how positive or negative the investment

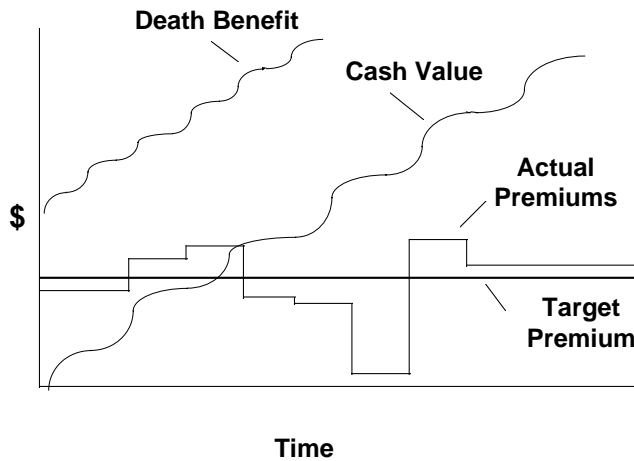
performance under the contract turns out to be. If the policyowner wants to have the death benefit vary with the performance of the investments under the contract, he or she must choose the increasing death benefit design. All of the increase or decrease is a direct result of the accumulation account balance, rather than the result of purchasing paid-up additions (or some form of modified premium addition) as is the case under fixed-premium life insurance.

Variable universal life policies offer the policyowner a choice among a specified group of mutual fund types or separate accounts that are created and maintained by the insurance company itself or by selected investment management firms.

Like variable life insurance, variable universal life insurance policies are securities and are subject to the same licensure and registration regulation (including a prospectus requirement) by the SEC and by the state insurance commissioners.



**FIGURE 3-11**  
**Variable Universal Life Type II or B**  
**Increasing Death Benefit**



### **Ultimate Flexibility**

Probably the easiest way to describe variable universal life insurance is to say that it is a universal life insurance policy with the added feature that the policyowner gets to choose the investments, as under fixed-premium variable life insurance contracts. Variable universal life offers the ultimate in both the flexibility afforded to the policyowner and the amount of risk shifted to the policyowner. There are no interest rate or cash value guarantees and very limited guarantees on the maximum mortality rates applicable. Policyowners have wide-open premium flexibility under this contract and can choose to fund it at whatever level they desire as long as it is at least high enough to create coverage similar to yearly renewal term and not in excess of the amount that would drive the cash accumulation account above the maximum threshold set forth in I.R.C. Sec. 7702. Policyowners do not need to negotiate with the insurance company or inform the insurer in advance of any premium modification or cessation.

These contracts permit partial withdrawals that work just like those under universal life policies. Early partial withdrawals may be subject to surrender charges, and surrender charges are applicable to total

surrenders in the policy's early years when the insurance company is still recovering excess first-year acquisition costs. The surrender charges vanish at a specified policy duration.

Variable universal life can be aggressively prefunded so that the policy can completely support itself from its cash value. If adequate premiums are contributed to the contract, this can be accomplished in a relatively short number of years. As with universal life and current assumption whole life, variable universal life policies have no guarantee that once the cash value is large enough to carry the policy it will always be able to do so. The policyowner assumes the risk of investment return and, to a limited extent, some of the risk of mortality rate charges. Consequently, the policyowner has to make adjustments and either pay more premiums or reduce the death benefit at some future time if in fact the cash value subsequently dips below the level needed to totally prefund the remaining contract years.

By choosing the increasing death benefit option under this contract policyowners are afforded an automatic hedge against inflation. This inflation protection is general in nature and subject to a timing mismatch in that investment experience may not keep pace with short-term bursts of inflation. Over the long haul, however, the investment-induced increases in coverage should equal, if not exceed, general increases in price levels.

As with variable life, the policyowner is able to switch investment funds from one of the available choices to any other single fund or combination thereof whenever desired. Some insurance companies put a limit on how many fund changes can be made without incurring explicit costs for those changes. Some companies allow one change of funds per year at no cost, others allow one change per open fund per year with no explicit charges, and others specify in the prospectus a given number of fund changes that can be accomplished during any given time interval (usually annually but sometimes other intervals such as quarterly or monthly) without incurring additional charges. Switching investment funds is accomplished without any internal or external taxation of inherent gains in the funds. The internal buildup of the cash value is tax deferred at least as long as the policy stays in force and will be tax free if the policy matures as a death claim.

Variable universal life insurance policies are still primarily life insurance contracts that generate cash value as part of the prefunding level premium mechanism. They are not strictly investment contracts and should not be viewed as such. Philosophically there seems to be a

conflict when policyowners manage variable life or variable universal life policies for maximum aggressive growth when in fact the reason for the contracts is to provide a financial safety net for beneficiaries. If the primary coverage is for its death benefits, it seems more appropriate that the investment allocations not pursue the most aggressive growth objectives. A more conservative growth approach is suggested.

On the other hand, if the primary objective for acquiring the contract is for its cash value and the policyowner intends to use the policy's cash values prior to the insured's death, perhaps the more aggressive growth stance is acceptable. In this case the policyowner is likely to be the beneficiary and the risk bearer.

### **Income Tax Burdens for Early Depletion**

Variable universal life policies should not be utilized as short-term investment vehicles. There are two potential traps for policyowners who significantly deplete the policy's cash values at various intervals during the first 15 policy years. These income tax burdens are in addition to any surrender charges that may be applicable within the policy itself.

One potential trap is the modified endowment contract provisions of the Tax Code, which treat all cash value distributions as taxable income until all investment returns have been taxed, and before the remainder of the distribution is treated as a recovery of capital. Such treatment is possible whenever material policy changes are made and the policy fails the seven-pay test (reaching the cash value amount for a policy paid up after 7 years). If the policy fails the seven-pay test, not only will the distributed amounts be subject to income tax (up to the extent of the gain); there may also be a 10-percent penalty tax applicable to those taxable gains if the policyowner is younger than 59 1/2 years of age. High cash value/high premium configuration variable universal life policies are the most likely candidates for this tax trap. Making sure that the cash value before and after any material change is lower than what it would be if the policy were fully paid up after 7 years will, in most cases, avoid this potential problem.

The other potential trap again deals with high levels of cash value approaching the upper limits permitted under the Tax Code. If a reduction in the death benefit level forces a distribution of the cash value in order to retain life insurance status under the Code, those distributions may be taxable income to the extent that they represent gain in the policy. The most stringent constraints apply to such "forced out" withdrawals during the first 5 years of the policy's existence. Slightly

less binding constraints are applicable for policy years 6 through 15. Any policyowner contemplating a switch from the increasing death benefit design to the level benefit design during the policy's first 15 years should consider these rules before making the switch. As long as there is no forced distribution or concurrent request by the policyowner for a discretionary distribution of cash value funds, there will be no problem. Conversely, if the increasing death benefit form of the contract is already prefunded near the maximum limitations, there is the possibility that some cash value will be forced out to maintain compliance with the Tax Code limitations on life insurance policies.

Neither of these tax traps has any consequence if there are no gains in the contract (premiums paid exceed cash value) when distributions are made. Also, under Modified Endowment Contract (MEC) provisions the taxation will be applicable only if there are distributions of the cash value. If the funds are left in the contract and allowed to remain part of the cash value, there will be no taxation even though the potential still exists for any distribution once the policy has become classified as a MEC.

Variable universal life contracts are not desirable for policyowners who do not wish to assume the investment risk under the contract. Potential policyowners who say they want to assume the investment risk but become extremely anxious over any short-term fall in the value of the selected investment portfolio funds should also be cautioned.



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# Chapter Three Review

*Key terms and concepts are explained in the glossary. Answers to the review questions and the self-test questions follow the Glossary.*

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## Key Terms and Concepts

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endowment life insurance	universal life insurance
IRC Se. 7702	target premium
adjustable life insurance	current assumption whole life
variable life insurance	interest-sensitive whole life
prospectus	indeterminate premium whole life
cost-of-insurance charge	redetermination
variable adjustable life insurance	variable universal life insurance

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## Review Questions

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- 3-1. Explain how endowment life insurance differs from whole life insurance and why endowment policies have nearly disappeared from new policy sales.
- 3-2. Explain why variable life insurance policies are subject to Securities and Exchange Commission (SEC) regulation, and describe the requirements that regulation imposes on the insurers, agents, and policies.
- 3-3. Describe the link between investment performance and death benefits under variable life insurance policies.
- 3-4. Explain how investment options have changed under many variable life policies over the past two decades.
- 3-5. Explain how the cash value of a variable life policy differs from that of a whole life policy.
- 3-6. Describe the type of information in a variable life insurance prospectus.
- 3-7. Describe the risks the policyowner assumes under a variable life policy.

- 3-8. Compare variable adjustable life insurance with adjustable life insurance.
- 3-9. Describe universal life insurance and explain why it was so successful in the 1980s.
- 3-10. Describe universal life insurance's flexible premium feature.
- 3-11. Explain how partial withdrawals of cash value from a universal life policy differ from a policy loan from that policy.
- 3-12. Explain the target premium concept applicable to universal life insurance.
- 3-13. Describe both of the death benefit options commonly available to universal life insurance purchasers.
- 3-14. Explain how policy loans affect universal life insurance's cash value and death benefit.
- 3-15. Describe the explicit loading charges and surrender charges in universal life insurance policies.
- 3-16. Describe current assumption whole life insurance, and explain why some of its variations have different names in the marketplace.
- 3-17. Describe the redetermination concept as it applies to current assumption whole life insurance.
- 3-18. Describe variable universal life insurance and explain how it differs from
  - a. universal life
  - b. variable life

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### Self-Test Questions

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*Instructions: Read the chapter first, then answer the following 10 questions to test your knowledge. Circle the correct answer, then check your answers in the answer key in the back of the book.*

- 3-1. Which of the following statements concerning variable adjustable life insurance is correct?
  - (A) The policyowner has the unilateral right to skip premium payments.
  - (B) Most companies marketing this coverage also market universal life.
  - (C) The death benefit can be less than the original amount of coverage if investment performance is lower than originally projected.
  - (D) The policyowner has a limited ability to choose the investment portfolio.

- 3-2. Which of the following statements concerning current assumption whole life is correct?
- (A) It has a redetermination feature that reconfigures the premium amount in light of recent experience.
  - (B) It is a variation of traditional whole life that provides no guarantees for the policyowner.
  - (C) Its cash value development is more like that of variable life than any other policy.
  - (D) It is participating insurance that has several unique dividend features.
- 3-3. Which of the following statements concerning universal life is correct?
- (A) The level death benefit option pays the constant amount at risk plus the cash value as a death benefit.
  - (B) If the universal life policy is underfunded, the policyowner has the choice to either (a) increase the premium or (b) reduce the face amount.
  - (C) Universal life policies require premium payments after the first policy year even if the policy's cash value is adequate to cover the next 60 days of expenses and mortality charges.
  - (D) Money can be withdrawn for a universal life policy, but it must be paid back with interest.
- 3-4. The target premium in a universal life policy is
- (A) the suggested premium to be paid on a level basis throughout the contract's duration
  - (B) the amount that must be paid on a universal life policy or it will lapse
  - (C) the maximum amount that is allowed to be paid on a universal life policy under Sec. 7702 guidelines
  - (D) The amount of premium that will guarantee that the policy will stay in force until age 95

- 3-5. Which of the following statements concerning adjustable life insurance is (are) correct?
- I. The adjustable life policy gives the policyowner the right to request and obtain a reconfiguration of the policy at specified intervals.
  - II. The adjustable life policy offers all of the same guarantees regarding cash values, mortality, and expenses as traditional whole life policies do.
- (A) I only
  - (B) II only
  - (C) Both I and II
  - (D) Neither I nor II
- 3-6. Which of the following statements concerning universal life insurance premium payment is (are) correct?
- I. At no time is there a required minimum level of premium payment.
  - II. Nearly every policy is issued with a target premium amount.
- (A) I only
  - (B) II only
  - (C) Both I and II
  - (D) Neither I nor II
- 3-7. Which of the following statements concerning current assumption whole life is (are) correct?
- I. Current assumption whole life has the same premium flexibility as universal life.
  - II. The cash value of current assumption whole life includes both guaranteed and nonguaranteed elements.
- (A) I only
  - (B) II only
  - (C) Both I and II
  - (D) Neither I nor II

3-8. All of the following statements concerning universal life insurance policies are correct EXCEPT

- (A) Under the increasing death benefit option the total death benefit equals the stated face amount plus the amount at risk.
- (B) Most policies credit current interest rates on the cash value as long as there are no outstanding policy loans.
- (C) Withdrawals effect future earnings because the fund still intact to earn interest is reduced by the amount of the withdrawal.
- (D) The target premium amount is merely a suggestion and carries no liability if it is inadequate to maintain the contract to any duration.

3.9. All of the following statements regarding variable universal life are correct EXCEPT

- (A) The policies do not permit the policyowner to direct the investment portfolio.
- (B) The policies treat all cash value withdrawals as policy loans.
- (C) The policies shift some of the investment risk to the policyowner.
- (D) The policies have either a level death benefit or an increasing death benefit.

3-10. All of the following statements concerning variable life insurance are correct EXCEPT

- (A) Advisors who sell variable life products must be licensed with both life insurance and securities licenses.
- (B) Variable life policies can be sold only after a prospectus have given to the prospective buyer.
- (C) Variable life policies become more acceptable to consumers after a long period of market increases.
- (D) Variable life policies provide guarantees of both the interest rate and a minimum cash value