LLQP STUDY NOTES

LESSON 9: Permanent Insurance – Interest Rate-Sensitive Insurance: Universal Life (U.L.)

- ***Universal life insurance*** is a combination of **insurance** and **investment** that offers flexibility unlike any other type of life insurance.
- The policy owner can:

  increase or decrease the **face amount** of the insurance (with evidence of insurability)

  add more lives to be insured under the policy

  substitute one life insured for another

  increase or decrease the **size** of the premiums

  increase or decrease the **length of time** premiums are paid

  change how the savings are **invested**
- In exchange for this flexibility, the policy owner must pay expenses to cover the costs the insurer incurs to administer the policy.
- There are three separate parts to a universal policy — **expenses, insurance** and, **investment**. The term used to describe this separation is ***unbundling***.
- Unbundling these costs shows the policy owner exactly how much growth is occurring in the account, the rate of growth, and the costs of insurance and expenses.

The Expense Component of a U.L. Policy

- Expense charges against the U.L. policy include:

  administration

  expenses

  sales costs
- Expenses are deducted monthly from the account.

The Insurance Component of a U.L. Policy

- The cost for insurance protection in a universal life policy is called the ***mortality charge***. It is based on:

  the age of the insured

the risk classification of the insured based on gender, smoking status, health factors, etc.

the face amount of the policy

the cost of insurance based on the net amount at risk (NAAR)

Type of Insurance

- The policy owner must choose how the cost for insurance will be based when the policy is issued. It can be either a **yearly term rate** (that will increase annually; based on yearly renewable term [YRT] rates) or a **level term rate** (that will remain constant, or *level*, for life; based on term-to-100 [T-100] rates and called the level cost of insurance [LCOI].
- The cost for insurance is deducted from the policy owner's account monthly.
- YRT premiums will be low initially, but as the insured ages, premiums will escalate.
- T-100 premiums may be higher initially, but will remain constant over time.
- The cash values in each policy also accumulate at different rates; T-100 builds cash value much faster then YRT.
- At some point the two rates will be equal. As a general rule, although this will vary depending on the age of the insured at onset, and interest rates, this point will be between eight and twelve years into the contract, and the cash values will be equal in about the twentieth year of the contract.
- Universal life policies are usually non-participating; that is, they do not receive dividends.

Premiums / Deposits

- A policy owner may deposit premiums and deposits to his or her universal life policy. Premiums are required to keep a universal life policy in force; they are used to pay the cost of insurance and other policy expenses. Deposits are optional; they are the extra put into the plan for investment.
- Deposits into the universal life policy build a pool of savings in the account, called the ***cash value***, or the ***accumulation fund***. As long as the *minimum* mortality charge and expenses can be paid from the cash value, there is no need for premium payments to be paid by the policy owner. The account value, however, is reduced by the absence of premiums. There is a maximum premium allowable; it is defined by a formula in the ***Income Tax Act***.
- If the maximum is exceeded, the policy loses its tax status as an insurance policy and is, instead, classified as a non-exempt policy subject to tax as an investment.

- If the policy owner fails to maintain enough funds in the account to pay the mortality charge and expenses, the insurer gives the policy owner a period of time, at least 30 days, to make a premium payment to cover the shortfall. If the policy owner fails to pay these charges, the policy will lapse.

The Investment Component of a U.L. Policy

- As premiums and deposits are made to the account, they can be invested in many investment products offered by the insurer, including savings accounts, guaranteed term deposits, mutual funds, and segregated funds.
- The policy owner chooses the investment product, monitors growth of the investment (which is made possible by unbundling), and makes the decisions regarding changing from one investment product to another.
- The investment growth within the account is tax-deferred. It is credited as interest income. Taxes are not paid until money is withdrawn.
- Choosing the appropriate investment for the policy owner will be based on:

    weighing risk vs. return

    past returns on the different types of investments available

    the risk tolerance of the client

    the client's need for guarantees

    the length of time the investment can grow before withdrawal

    the intended use of the funds

    the personal preferences of the investor

    types of investments available

Risk vs. Return

- The riskier the investment, the higher the potential return.
- It is possible to allocate funds partly towards riskier investments (to increase returns) and partly towards conservative investments (that will have a lower rate of return).
- An investor who invests only in the most conservative investments runs the risk of inflation outpacing investment return.

Past returns

- Past returns will provide an idea as to the returns offered by one type of investment (e.g., savings accounts) compared to another (a mutual fund, for instance). However, they must NEVER be considered an indication of future returns.

Risk Tolerance

- It is essential to understand the risks inherent in the different types of investments that can be acquired through a universal life policy.
- Once investment risk has been determined, it is possible to match it with the risk tolerance of the prospective policy owner. Risk tolerance is determined by the client's:

  personality (some personality traits show a higher risk tolerance)

  age (younger people are more accepting of risk)

  experience (positive risk-taking experiences encourages more risky behaviour)
- A Risk Tolerance Questionnaire or Client Profile Questionnaire can be a useful tool to determine client risk tolerance.

Guarantees

- There is no guarantee the policy owner will get all deposits returned unless seg funds or another guaranteed investment (i.e., GIC) are acquired.
- Segregated funds are an option that does guarantee a minimum return of 75% of money invested after ten years. Some offer a 100% guarantee. Mutual funds offer no guarantees.

Time for Growth

- The longer the investment stays in the policy, the greater the chance for growth. This is particularly true considering the power of compounding. Also, investing for the long term reduces the impact of market fluctuations.

Intended Use of Funds

- There are different uses of funds that will dictate risk vs return. Care for a dependent child or retirement would indicate little risk with a high need for guarantees. A less serious need such as travel would mean guarantees are less important.

Preferences

- What the client *wants* to do is of foremost importance. A client can be guided by needs of which the agent is unaware (e.g., the ethical issues that surround investment in certain mutual funds).

Types of Investments Available

- The types of investments available for the universal life policy owner range from **very conservative** low risk investments (such as GICs that provide a low rate of return) to **highly speculative** high risk investments (such as global equity funds that may provide a very high rate of return).

The Danger of Leveraging

- Leveraging uses borrowed money to invest.
- Leveraging can work two ways with a universal life policy:

  a policy owner could borrow money from a bank to invest in a universal life policy. If the cost of borrowing was 6% annually, the returns on the investments in the policy would need to be greater than 6% to produce a positive gain and pay expenses. If the returns were 3%, the policy owner would actually be losing money by borrowing to invest (leverage).

  a policy owner could borrow against the policy's cash value to invest in stocks, for instance. In that case, if $20,000 was borrowed from the policy (called a *partial surrender*) and the stocks, or other investment, then decreased in value, the loan might not be repaid and, consequently, the death benefit of the policy would be reduced.

- Successful leveraging means that the investor must be able to earn higher returns on the investment than the cost of borrowing, and still be able to repay the principal on the loan.

Other Features of Universal Life

- Like whole life insurance, universal life offers:

  a cash surrender value (CSV)

  policy loans

  premium offset

- Unlike whole life, it also provides the ability to take a cash withdrawal from the policy.

Cash Surrender Value

- The CSV of the policy is the total account value minus outstanding loans minus surrender charges.
- The **account value** is the total of all the investments in the investment account or accounts less deductions for the current month's expenses.
- Many policies have a ***back-end surrender*** charge that applies if the policy is surrendered. These may apply up to 20 years after the policy was issued.

Policy Loans

- A universal life policy loan is usually available.
- The amount borrowed cannot exceed the cash surrender value of the account. There will be a tax implication if the loan exceeds the ACB. Also, death benefits will be reduced by any outstanding balance on the loan, plus interest.

Premium Offset

- Future premiums can be eliminated by paying larger than required premiums in the early years of the policy.

Cash Withdrawal (Partial Surrender)

- Universal life policies provide the policy owner with the option to make a cash withdrawal from the account value of the policy.
- Unlike a loan, this withdrawal, called a ***partial surrender***, does not have to be repaid.
- If not repaid, it will reduce the amount of death benefit that is paid. There may be tax implications of a withdrawal.

Universal Life Death Benefits

- Universal life provides a choice of death benefits.
- The policy owner selects his or her preference when the policy is issued.
- The four death benefit choices are:

  a **level death benefit:** the face amount of the policy. If the account value begins to approach the face amount, the death benefit will increase proportionately to the account value. This option carries the lowest premium.

  a **level death benefit** *plus* **total account value:** the level death benefit *plus* the gross value of the account(s) less deductions and expenses. Thus, the face amount is *adjusted* by the gross value of the **investment account**. This option typically carries the highest premium.

  a **level death benefit** *plus* **cumulative gross deposits**: the level death benefit *plus* the amount of each gross deposit before premium taxes, deductions and expenses. Thus, the face amount is *increased* by the **deposits.** The premium cost will be higher than a level death benefit.

  a **death benefit, indexed**: the death benefit *plus* a percentage that is either tied to the Consumer Price Index (CPI) or to a number chosen by the policy owner that reflects a cost of living increase between one and eight per cent. In this way, the death benefit is protected against the effects of inflation; the policy owner funds this protection through a premium that will be higher than if a level death benefit was chosen.

Summary of Universal Life

For [illegible]l life application of this theory, see the Case Studies in the Text.

- The **advantages** of a universal life policy include:
  - **Flexibility**: The flexibility offered in a universal life policy is an attractive feature that customizes the product for individual needs.
  - **Liquidity**: The policy owner can quickly access the cash value of the policy if he or she has an immediate cash need.
  - **Estate planning**: Universal life is a permanent policy. It is therefore highly effective for estate planning purposes because it can be used for expenses that must be paid after death, such as tax and capital gains. It also provides a tax-free bequest to a chosen beneficiary or beneficiaries.
  - **Control**: The policy owner is able to control and manage the cash reserves to take advantage of investment opportunities as he or she perceives them. For example, if the policy owner is convinced that the stock market will begin to rise after a period of decline, he or she can move into equity mutual funds.
  - **Protection from creditors**: Universal life provides the same protection from creditors as whole life insurance during life and on death.
  - **Favourable tax treatment:** Cash value of the policy grows on a tax-deferred basis, thus producing compound growth. Proceeds are received by the beneficiary tax-free.
- The **disadvantages** of universal life include:
  - **Evidence of Insurability:** Increasing the face amount or adding a new life will require evidence of insurability.
  - **Premium Requirements**: As with many types of permanent insurance, universal life premiums must be paid for the lifetime of the policy owner.
  - **Cost of Insurance:** The insurance in a universal life policy is YRT or T-100; YRT premiums will increase every year for the duration of the policy. Thus, the insurance expense element of the policy will become costly when the policy owner becomes older and more of the premium will be directed towards the insurance component while less is then available for investment.
  - **Death benefit value:** The choice of death benefit must be made when the policy application is made. Its value will vary depending on the type of benefit selected and the performance of underlying investments.
  - **No direct investment in stocks or bonds:** The savings portion is invested in products offered by the insurer. These products include savings accounts,

guaranteed term deposits, mutual funds, and segregated funds. There is no opportunity to invest directly in stocks, bonds or other investments.

- **Higher administration fees:** Higher administration fees are charged to pay provincial taxes, mortality deductions, rider charges, and annual ad-ministration expenses.
- **Complexity of product:** Universal life is the most complex of the insurance products. Some clients may be incapable of understanding all the factors that are involved in the policy.
- **Requirement for investment knowledge**: The policy owner must have the knowledge and confidence to select and switch investments. He or she must also monitor this aspect of the policy. Many clients like to refer such decisions to "professionals" since they feel inadequate to make these types of decisions.