Equity Indexed Universal Life - A Call to Action

The Need for Consumer Intervention has Increased

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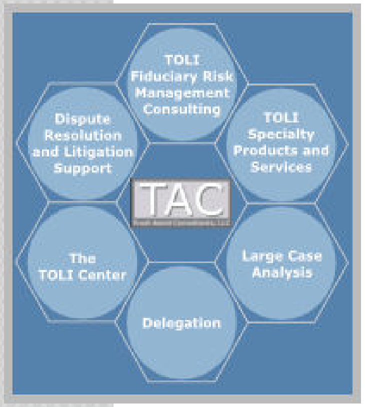


The TOLI Center

Introduction

This purpose of this presentation is to discuss the suitability, design and prudent risk management of Equity Indexed Universal Life (EIUL), a "hybrid" life insurance product that warrants "hybrid-specific" attention. This presentation is a follow-up 'companion' to our articles,

- ***Equity Indexed Universal Life Insurance – A Call to Action*, in the Society of Financial Service Professionals' April 2015 Risk Management Newsletter, and**

- ***EIUL Call to Action – The Need for Consumer Intervention Has Increased*, in Tax Facts Online September 2015**

EIUL marketing practices have been described as misleading and deceptive, resulting in regulator intervention. Following recent illustration guidance (AG49), the performance of all 'inforce' EIUL policies should be (1) reviewed using credible policy evaluation, and (2) monitored annually to maximize the probability of a favorable outcome to the policyowner's planning objectives.

This presentation addresses basic product suitability considerations so that legal, tax and financial advisors are aware of the product selection trade-offs.

Equity Indexed Universal Life (EIUL) has been the subject of misleading and deceptive sales practices[1].

- Inconsistent look-back periods for policy illustrations – an issuer could select whatever period maximized the illustrated crediting rate of its Indexed methodology.

- Crediting rates tied to the price movement of different indices – no disclosure correlation to the Total Return.

- Because EIUL is not a security, non-securities licensed agents are restricted from discussing / disclosing market correlations or how the product "fits" with the consumers Personal Financial Planning.

- Because EIUL is not a security, securities licensed agents are not provided the market correlations and equivalent Total Returns to (1) adjust policy illustration rate consistent with the consumers Personal Financial Planning and (2) to ensure they are compliant with FINRA's 10% gross hypothetical illustration rate cap.

This 'hybrid' has become the 'product du Jour' and the subject of 'win the illustration beauty contest' caveat emptor alerts.

1. New York State Financial Services Superintendent Benjamin Lawsky investigation of EIUL sales practices, described as deceptive and misleading.

NAIC (National Association of Insurance Commissioners) Actuarial Guideline 49 (AG49)

- Response to EIUL illustration abuse and issuer inconsistency.
- Effective September 1, 2015.
- Controls the maximum interest rate permitted to illustrate new and inforce EIUL policies.
- Specifies a 65-year look-back period and series of 25-year measurement periods that all EIUL illustrations must use.
- By extension, AG49 also provides differentials the Society of Actuaries considers appropriate between types of Universal Life Insurance products.

It is important to understand that AG49 simply establishes a 'maximum' permitted EIUL illustration rate but the 'maximum' has *no relevance* to the crediting rate (investment return) a purchaser considers realistic for longer-term planning.

Inconsistent Agent Roles

State regulations do not permit a non-registered rep licensed life insurance sales agent to provide investment advice or discuss investment-related issues specific to this product.

- A non-securities licensed agent can sell the policy.
- Only a securities licensed agent can discuss EIUL's fit in the investment driven marketplace and ongoing investment driven decisions the policy owner must make.

These are the core misleading and deceptive practices discussion issues that must be addressed in order for the agent to demonstrate a suitability determination.

If they are not addressed, a 'dispute defensible ' suitability determination cannot be made and the policy purchaser is likely exposed to illustrated policy values that cannot be achieved.

Total Return Equivalent

To explain the misleading marketing practices issue, we applied the S&P 500® Total Return to the 2015 AG49 (1) data period and (2) 25-year returns:

- 12.44% average of 1-year periods – 16.63% Standard Deviation.
- 10.90% average return of the 25-year blocks of 1-year periods.

Hence, without intervention, consumers may be shown an illustration having a 6.65% AG49 compliant illustration rate that is calculated assuming a 10.90% average Total Return of the 25-year blocks.

However, is this 10.90% 'look back' Total Return assumption consistent with a consumer's 6%-8% 'look forward' Personal Financial Planning Total Return objective?

Assuming an 8% Total Return planning objective, this EIUL policy should be illustrated at 4.88%, not 6.65%.

Intervention and the Form It should Take for a Buy-Fund-Manage Life Insurance Product

Intervene is defined "come between so as to prevent or alter a result or course of events".

Intervention is important to the purchaser of flexible premium non-guaranteed life insurance products – Universal Life (UL), Variable Universal Life (VUL) and Equity Indexed Universal Life (EIUL) - because these are buy-fund-manage products.

- The **'buy'** function usually is based upon an issuer illustration that (1) disclaims predictive value and (2) assumes a crediting interest rate selected by the sales agent, not the purchaser.
- The **'fund'** function refers to annual premium payments that require periodic adjustment based upon the actual policy crediting rate and charges controlled by the issuer.
- The **'manage'** function is not provided by the issuer nor the sales agent. **Rather, the 'manage' function is solely the responsibility of the policy owner.**

Since most purchasers have no idea they have assumed performance risk, intervention is needed to 'credibly' determine if the scheduled 'fund' premium will sustain death benefit coverage to insured life expectancy and avoid unexpected policy lapse without value.

Intervention

AG49 is important to consumers because its interpretation now provides NAIC and Society of Actuaries illustration differentials between Universal Life (UL), Equity Indexed Universal Life (EIUL) and Variable Universal Life (VUL / CVUL).

- Intervention should also incorporate Monte Carlo Simulations based on the consumer's future market expectations. Life insurance illustrations typically utilize a level rate-of-return based on current market returns, or in the case of EIUL, how the market has performed the past 65 years. The combination of AG49 and Parameterized Return Monte Carlo Simulations allows the consumer to assess the risk / return of different policy forms utilizing a common starting point – the consumers S&P 500® Total Return planning assumption.

- Intervention should also include FINRA comparative analysis best practices - FINRA Rule 2210(d)(4)(C) governing "hypothetical illustrations of financial principles" provides the methodology for illustrating different structural and tax alternatives.

Intervention based on NAIC and FINRA best practices safeguards the policy owner's planning objectives.

The EIUL "Consumer" Comparative Problem

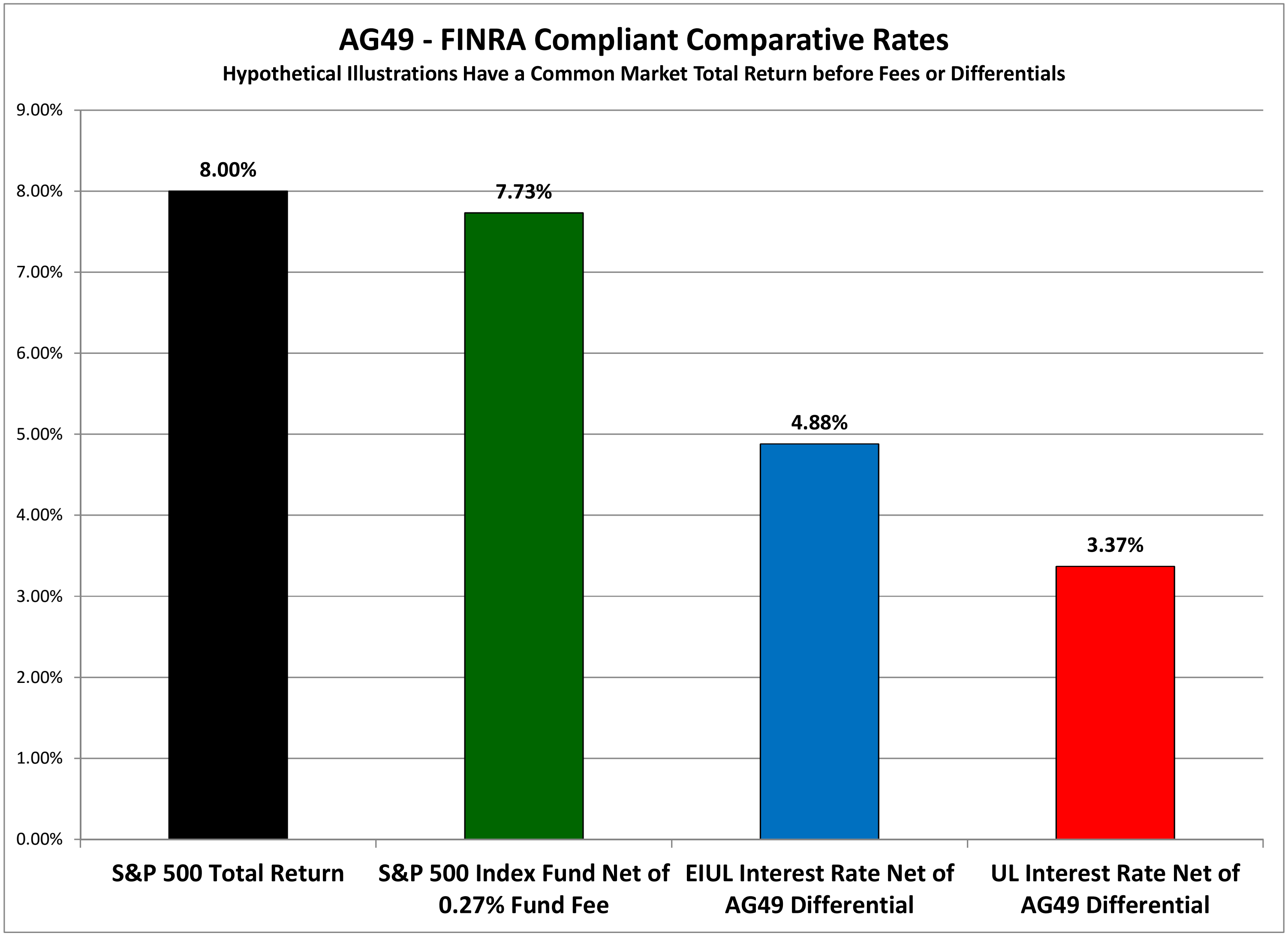
Because EIUL is not a security, two problems exist:

- Non-securities licensed agent have been free to devise whatever comparatives to other planning and investment management structures (401(k), IRA, Taxable Brokerage Account, 409A, Annuity, etc.) that best demonstrate the benefit of purchasing the EIUL policy.
- Securities licensed agents have not been provided the Total Return equivalences to prepare FINRA compliant comparatives to other market influenced alternatives.

AG49 now provides the differentials so that meaningful comparatives to other life insurance and investment alternatives can be made based on FINRA best practices.

Applying AG49 Differentials

Assume a 6.65% AG49 EIUL policy rate and an 8.00% consumer S&P 500 Total Return Planning assumption. The AG49 differential results in a 4.88% EIUL rate.



Examples of Applying AG49 Differentials

We have assumed:

- Male age 50 Preferred Non-smoker.
- $1 million Protection – Option B Increasing Death Benefit in all years.
- 20 year premium solve based on (1) the issuers EIUL 6.65% illustration rate and (2) policy survival to age 121.

Single Issuer to Ensure Relative Pricing Methodology Consistency:

- 6.00%, 8.00% and 10.00% S&P 500® Total Return assumptions.
- Universal Life and Institutionally-priced Variable Universal Life* comparatives.
- Cash Surrender Value Comparison – Death Benefits are the cash values <u>plus</u> $1 million.

We have utilized "apples to apples" assumptions to the extent possible so the only material difference is the AG49 differentials on Total Return assumptions.

Hence, "all things being equal", what do these three policy forms offer?

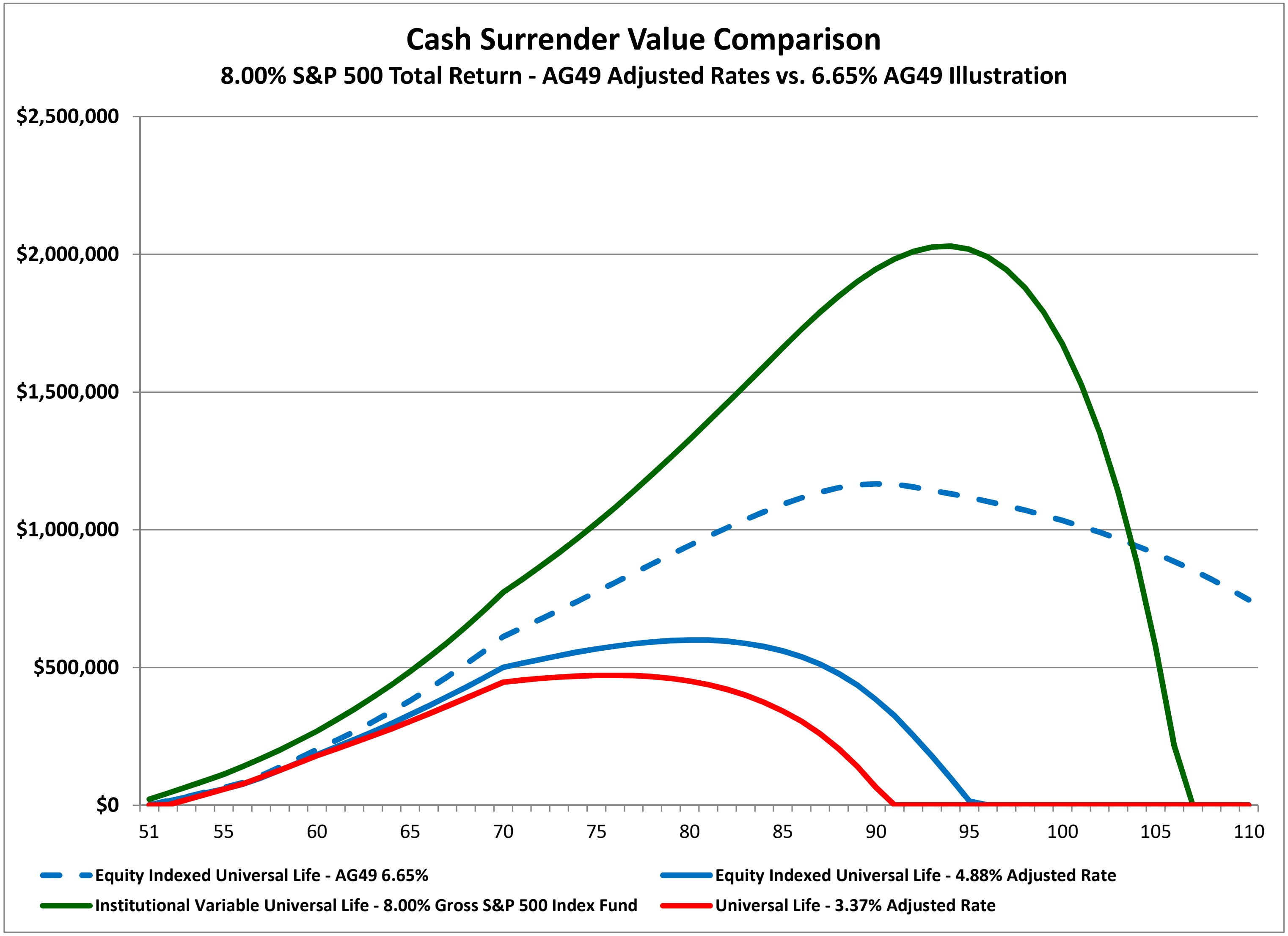
Note: We have illustrated the Option B Increasing Death Benefit in all years to (1) demonstrate the long-term policy survivability risk of maintaining this option and (2) the different effects on cash values of retail front-loaded mortality cost and institutional life insurance cash management oriented policies.

Applying AG49 Differentials

Assumes 8.00% consumer S&P 500 Total Return Planning assumption.

Reducing the Total Return from 10.90% to 8.00% reduces the EIUL policy survival from age 121 to age 96.

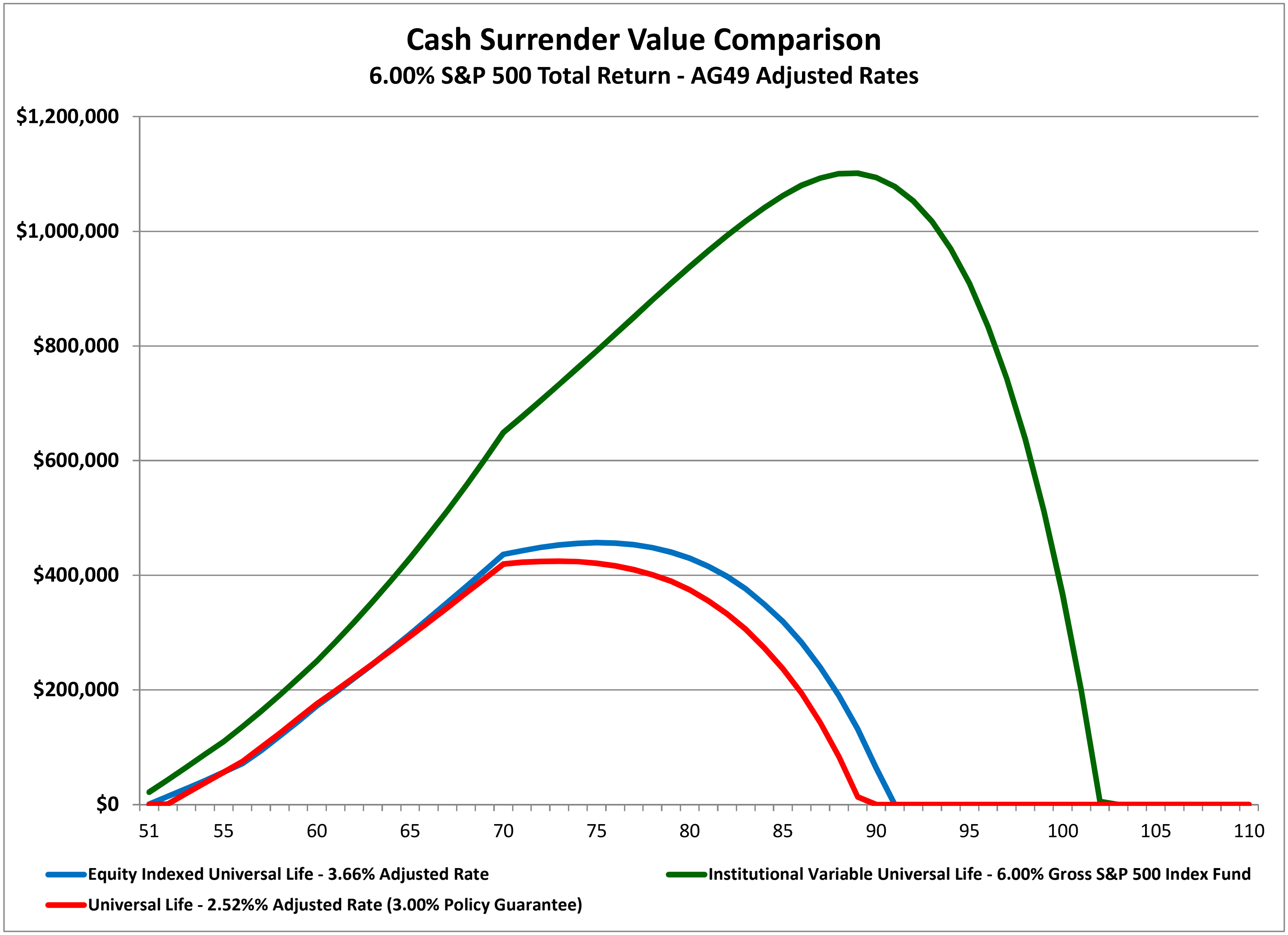
Front-loading EIUL mortality rates results in (1) reduced early cash accumulation and (2) extended long-term survival.



Applying AG49 Differentials

Assumes 6.00% consumer S&P 500 Total Return Planning assumption.

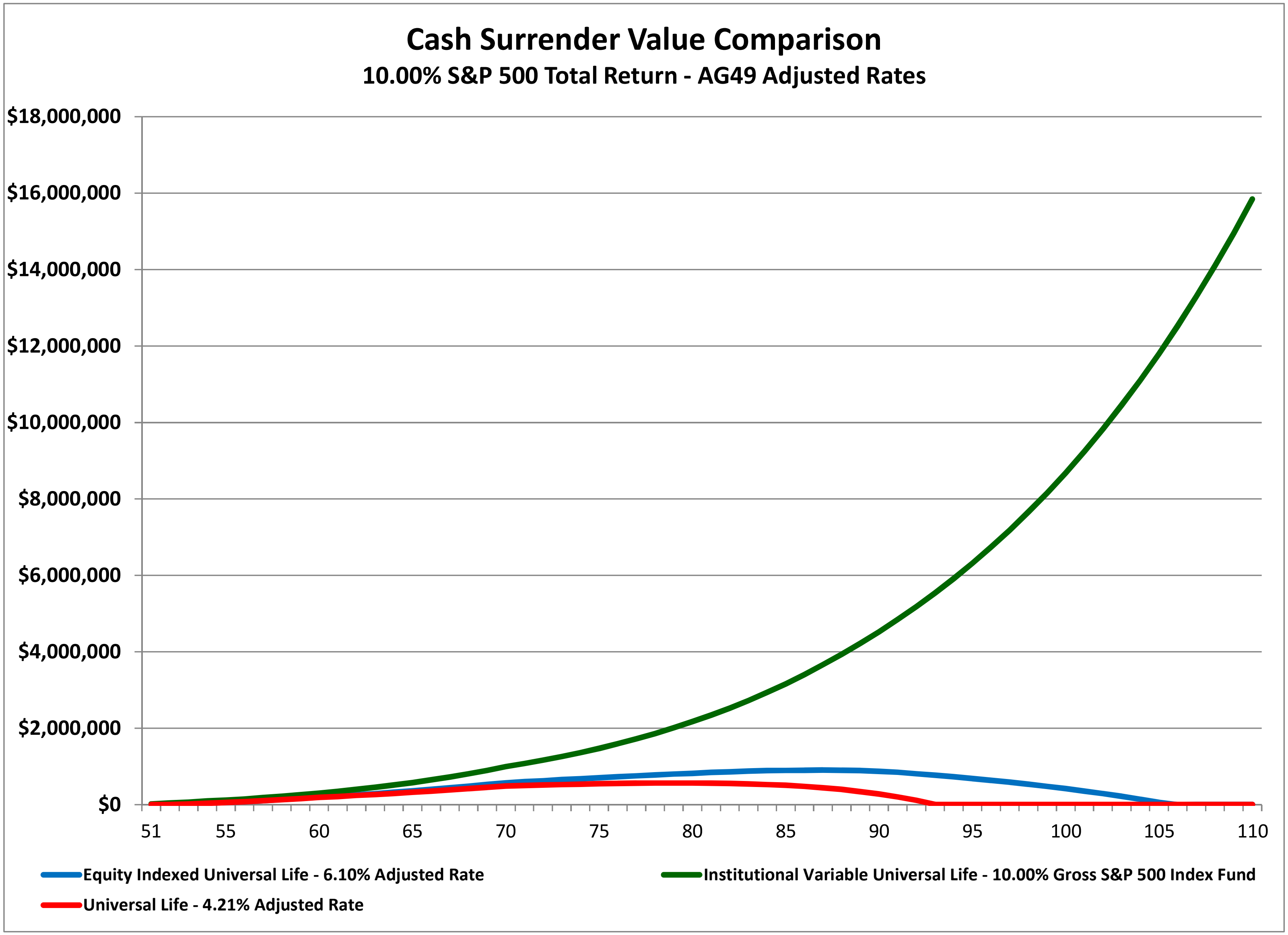
Reducing the Total Return from 10.90% to 6.00% reduces the EIUL policy survival from age 121 to age 91.



Applying AG49 Differentials

Assumes 10.00% consumer S&P 500 Total Return Planning assumption.

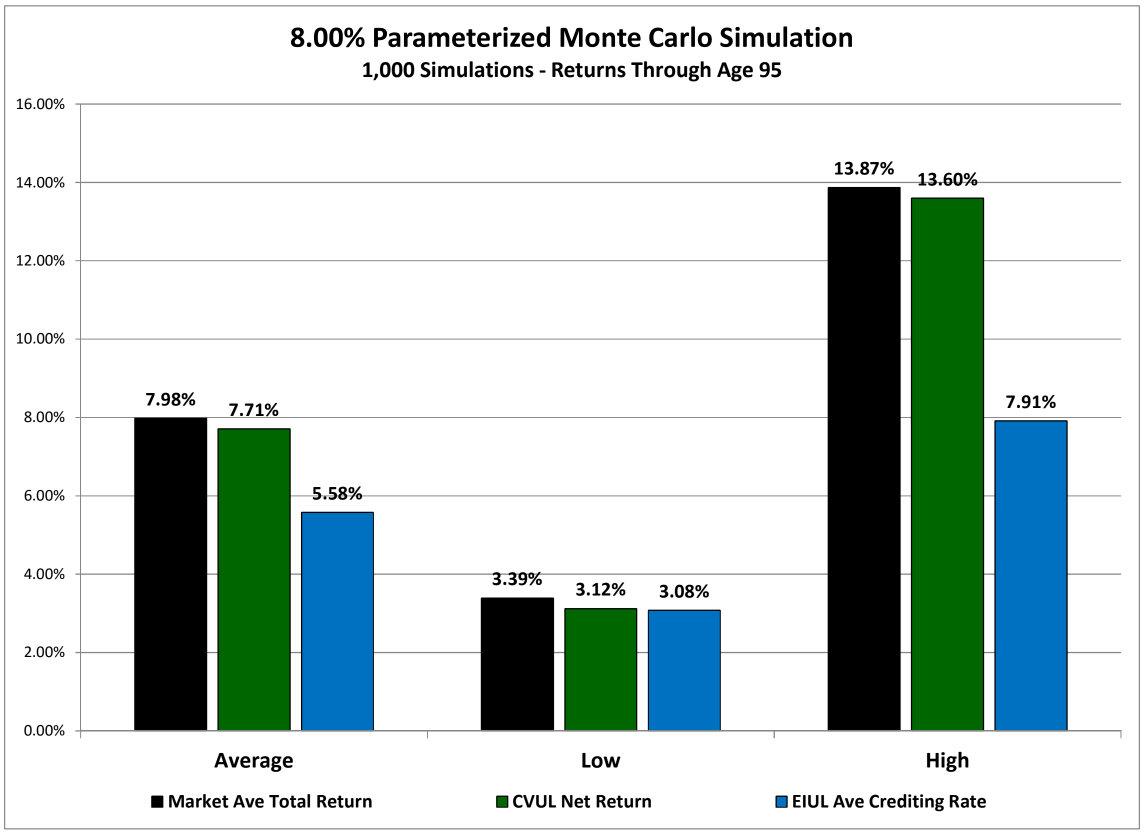
Reducing the Total Return from 10.90% to 6.00% reduces the EIUL policy survival from age 121 to age 106.



Applying Monte Carlo to the 8.00% Total Return

Parameterized Return Monte Carlo Simulations utilize a user specified Mean Return (Total Return) and Standard Deviation (Volatility) to simulate future returns rather than replicate returns of the past.

Parameterized Return allows us to stress-test the EIUL Indexed Methodology based upon current Personal Financial Planning assumptions.



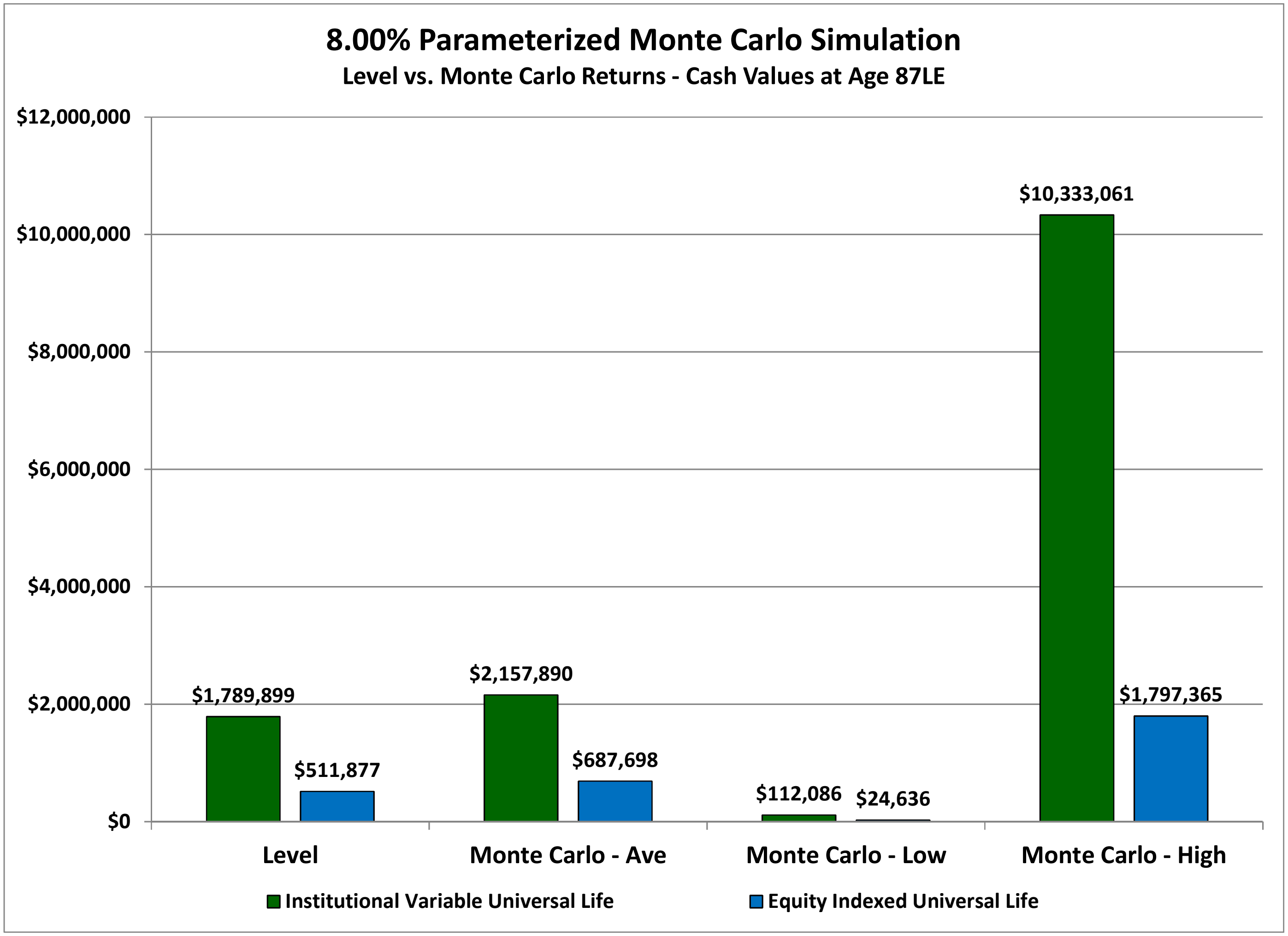
Note: The 5.58% EIUL average exceeds the 4.88% AG49 Adjusted rate because the current 8.55% S&P 500 Standard Deviation is significantly less than the 12%-17% rates of the past.

Applying Monte Carlo to the 8.00% Total Return

Parameterized Return Monte Carlo Simulations demonstrate:

- The different values resulting from Level or Monte Carlo returns.
- The impact of EIUL caps, floors and pricing.

Values at Age 87 Average Life Expectancy.

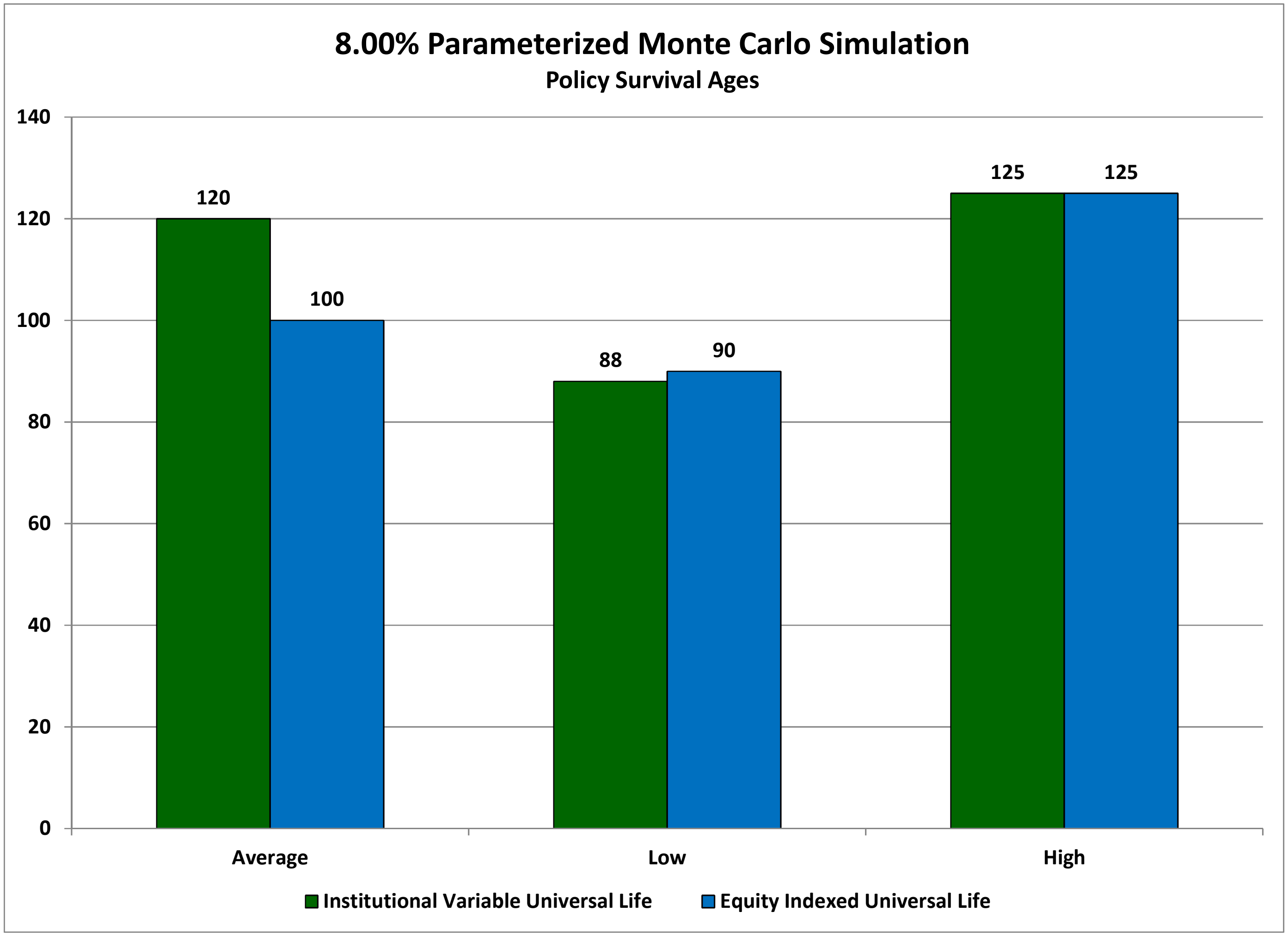


Applying Monte Carlo to the 8.00% Total Return

Parameterized Return Monte Carlo Simulations demonstrate:

- The different policy funding survival ages.
- The impact of EIUL caps, floors and pricing.

Policy Survival Ages

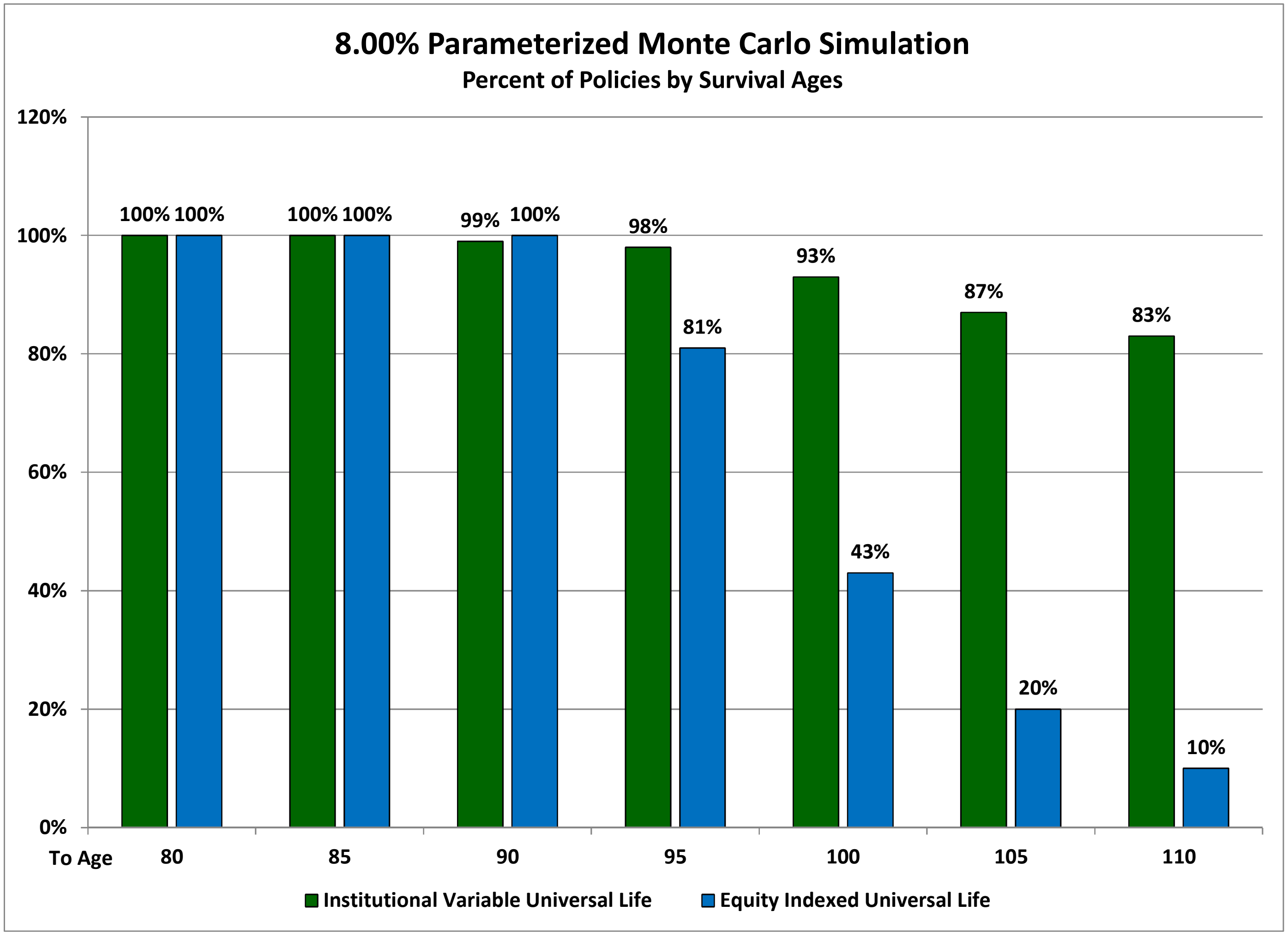


Applying Monte Carlo to the 8.00% Total Return

Parameterized Return Monte Carlo Simulations demonstrate:

- The different policy funding survival ages.
- The impact of EIUL caps, floors and pricing.

Percent of Policies to Attain Policy Survival Ages



Resetting Expectations

Monte Carlo Simulation demonstrates:

- EIUL differential could be less than the AG49 adjustment if the S&P 500 / markets continue to produce less volatility than in the past – the higher the volatility, the greater the difference between Total Return and the Indexed Methodology.
- Returns above the 8.00% Mean / Total Return assumption have greater positive impact than lower returns have negative impact.
- The value of the EIUL 0% ('down market'} crediting floor is more than offset by the policy contract's caps on investment gains.

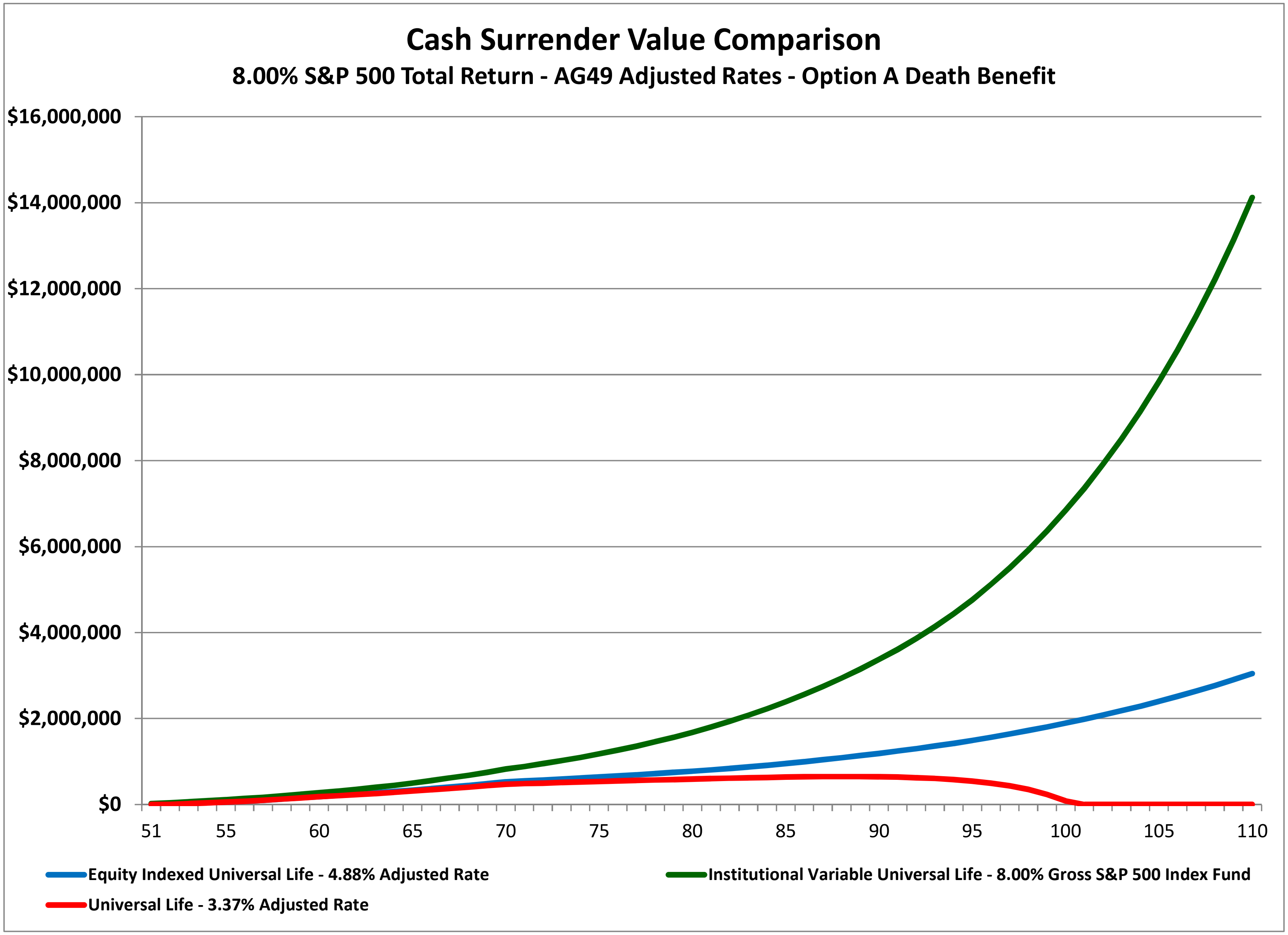
It is important to remember that EIUL does not change the underlying volatility of the Index / Indices; rather, EIUL merely limits its loss and returns.

EIUL can be described as a 'gimmick' product because it appears to minimize and contain customary investment risks. However, it simply re-characterizes these risks that still require annual attention, limits the sales agent role, and requires intervention engagement to achieve a prudent and reasoned policy management process.

Applying AG49 Differentials

Assumes 8.00% consumer S&P 500 Total Return Planning assumption.

Switching to Option A (Level) Death Benefit as soon as possible to maximize cash values and policy survival.



Summary

Consumer Intervention is Needed More than Ever

- NAIC AG49 contained EIUL illustration rates but did not address the equivalent market Total Return consumer disclosure problem.
- Non-securities licensed agents are restricted from conducting intervention and providing a 'dispute defensible' suitability determination.
- Extension of AG49 to S&P 500® Total Return provides differentials between different forms of Universal Life products.
- FINRA Rule 2210(d)(4)(C) governing "hypothetical illustrations of financial principles" provides the methodology for illustrating different structural and tax alternatives.
- Parameterized Return Monte Carlo Simulations stress test different pricing structures under a common set of variable return illustrations.
- ALL EIUL policies issued prior to September 1, 2015 require re-illustration and annual performance monitoring Intervention.
- All EIUL consumers should re-evaluate whether the EIUL investment methodology and its management implications are suitable for their long-term planning as compared to traditional index fund or asset allocated fund investing.

About the Authors

Following is contact and brief background information concerning each co-author.

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- ILIT Administration and Trust-Owned Life Insurance (TOLI) experience.
  - Banking and Trust executive management.
  - 20+ years consulting to skilled and unskilled ILIT trustees, legal and tax advisors, family offices, affluent family groups and ILIT beneficiaries.
  - Active Dispute Resolution and Expert Opinion/Witness consulting practice, including Cochran v. Key Bank matter.
  - Lecturer at Heckerling Institute January 2014

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- 30+ Years Life Insurance Technical Support.
- 25+ Years Executive Benefits Design and Plan Administration.
- 20+ Years ILIT Administration and Trust-Owned Life Insurance (TOLI) experience.
- 2002 – Creator, Sponsor and Administrator of The STAR Plan featuring ILI.
  - Individual / Trustee access to Institutionally-priced Life Insurance.
  - Professionally administered IRC §7702 based cash, tax, investment and risk management strategy.
  - The STAR Plan brings the Institutional Life Insurance (ILI) value proposition utilized by corporations (COLI) and banks (BOLI) to the individuals whose career and life achievements make ILI's superior value proposition possible for their personal investment, retirement and estate planning.