



UNIVERSAL LIFE INSURANCE: LEGAL, REGULATORY AND ACTUARIAL ASPECTS

Author(s): Alan Lazarescu and Harold Leff

Source: *The Forum* (American Bar Association. Section of Insurance, Negligence and Compensation Law), Vol. 17, No. 4 (Spring 1982), pp. 1000-1011

Published by: American Bar Association

Stable URL: <https://www.jstor.org/stable/25762686>

Accessed: 01-01-2020 03:28 UTC

JSTOR is a not-for-profit service that helps scholars, researchers, and students discover, use, and build upon a wide range of content in a trusted digital archive. We use information technology and tools to increase productivity and facilitate new forms of scholarship. For more information about JSTOR, please contact support@jstor.org.

Your use of the JSTOR archive indicates your acceptance of the Terms & Conditions of Use, available at <https://about.jstor.org/terms>



American Bar Association is collaborating with JSTOR to digitize, preserve and extend access to *The Forum* (American Bar Association. Section of Insurance, Negligence and Compensation Law)

UNIVERSAL LIFE INSURANCE: LEGAL, REGULATORY AND ACTUARIAL ASPECTS

Alan Lazarescu and Harold Leff

Universal life. Barely a year ago, few people outside the life insurance business knew what it was. Some may have thought universal life was for space shuttle travelers. Others may have thought it was Ponce de Leon's fountain of youth. Few would have known it was an individual life insurance policy which some feel has the potential to change the life insurance industry. Today, we have complete life, the solution, the challenger, T-plan life, life cycle, etc. We have the industry splitting into the Hatfields and McCoys over major issues such as replacement and taxation. Over the course of the next hour, Alan and I hope to bring you up to date on (1) the product, where it is and where it's going; (2) commission-related questions; (3) financial considerations, replacement, and administrative questions and systems requirements; (4) legal and regulatory issues; and last but far from least (5) taxation.

The roots of the traditional life insurance products have existed virtually unchanged for over 200 years. During this period, the industry has grown with products that provided for payment of fixed premiums and fixed death benefits, but further growth may now be limited. The industry has had no real growth (after inflation) in individual premium income for the past ten years. The insurance industry's share of savings has declined significantly over the last three decades. The overall composite lapse rate of ordinary policies has increased substantially during the last few years.

The center of the problem is inflation. The consumer has only limited alternatives in using the life insurance product, which he generally views without real understanding or satisfaction. These problems led to the development of universal life as a possible response. A proposed California guideline on universal life defines the product as "any plans,

Alan Lazarescu is Assistant General Counsel for the Metropolitan Life Insurance Company.

Harold Leff is an actuary with the Metropolitan Life Insurance Company.

other than variable life insurance or variable annuity plans, whereby premiums or considerations are paid into a fund from which the cost of any benefits, life insurance, or annuity, or any other benefit, is deducted and into which investment earnings on the fund are added and certain specified expenses are deducted." Note that universal life is a completely flexible policy, both as to premium and amount of insurance. After the initial premium, there are no premium due dates. There are no required premium payments. The policyholder can vary his amount of insurance at his whim and fancy, although amount increases are subject to evidence of insurability and a one-time underwriting expense change. However, if sufficient premium is not paid, the policy may lapse if the cash value is eventually depleted.

Universal life is designed to be whole life insurance. Many policies provide for maturity at age ninety-five, although depending on the relationship between premiums paid and benefits provided, the policy can be anything from pure term insurance to an endowment policy. The policy provides for two types of death benefits. Under the first option, the death benefit is the face amount inclusive of the cash value. Under the second option, the death benefit is the face amount plus the cash value. Perhaps a simple example would be useful here. Let's assume a typical universal life policy, if the word typical has any meaning. There are three key areas—expenses, mortality and interest. (See figure 1).

FIGURE 1

Typical Universal Life Policy

EXPENSE LOADS

First Year Only	\$252 per policy (\$21 per month) \$1.08 per \$1,000 (\$.09 per month)
All Years	10% of premium

Looking at expenses first, most universal life products charge for expenses directly in three pieces, although some may not use all three components. There is usually a first year charge, such as \$252 per policy and \$1.08 per \$1,000 of face amount. These may seem like odd amounts, but they are each divisible by 12, and one of the features of universal life, as we will see in a few minutes, is monthly processing. There is also a level percentage load of 10 percent of each premium payment. There are no other direct expense charges, although there may be indirect recognition of some expenses in the determination of mortality charges and interest credits.

Looking at the second key area, mortality costs are charged based on the net amount at risk—i.e., the death benefit less any cash value. (See figure 2.)

FIGURE 2

*Typical Universal Life Policy***EXPENSE LOADS**

First Year Only	\$252 per policy (\$21 per month) \$1.08 per \$1,000 (\$.09 per month)
All Years	10% of premium

MORTALITY CHARGE—AGE 35

Guaranteed	\$2.76 per \$1,000 (\$.23 per month)
Current	\$2.04 per \$1,000 (\$.17 per month)

The policy guarantees maximum mortality charges in the contract. At age 35, the guaranteed mortality cost might be \$2.76 per \$1,000 of insurance. Actual mortality is charged on an indeterminate premium basis, subject to the contractual maximum. The current mortality charge at age 35 might be \$2.04 per \$1,000.

Considering the third key area, interest, the policy provides for a guaranteed rate of interest of 4 percent. Excess interest, above 4 percent, may be declared by the insurer. (See figure 3.)

FIGURE 3

*Typical Universal Life Policy***EXPENSE LOADS**

First Year Only	\$252 per policy (\$21 per month) \$1.08 per \$1,000 (\$.09 per month)
All Years	10% of premium

MORTALITY CHARGE—AGE 35

Guaranteed	\$2.76 per \$1,000 (\$.23 per month)
Current	\$2.04 per \$1,000 (\$.17 per month)

INTEREST CREDITED

Guaranteed	4% per year
Current	11.75% per year (0.93% per month) except 4% on first \$1,000 of cash value and on any amount borrowed under policy loan provision.

This particular policy provides that no excess interest will be credited on either the first \$1,000 of cash value or on any amount which is borrowed under the policy loan provision (more about loans later). Let's assume that guaranteed plus excess interest is credited at an effective annual rate of 11.75 percent—this is equivalent to 0.93 percent per month.

Now let's for the moment assume that Alan has just bought this pol-

icy and has decided to pay \$500 on the issue date, and \$100 on each monthly anniversary. Remember, these \$100 payments are not required, and he may decide to skip one in June to finance a visit to Atlantic City. Now let's further assume that Alan is 35 years old—well, I didn't say all of the assumptions would be realistic. We'll further assume that the face amount is \$100,000 and Alan has chosen death benefit option B—i.e., the death benefit will be \$100,000 plus the cash value. This will simplify the numerical calculations.

On the date of issue, Alan pays a \$500 premium. The insurer deducts the 10 percent load, crediting the balance of \$450 to the cash value. (See figure 4.) The insurer then makes the current monthly deductions from the cash value—\$21, which is one-twelfth of the \$252 per policy charge; \$9 which is one-twelfth of the \$1.08 per \$1,000 underwriting charge, times 100 (since \$100,000 of insurance is being provided); and \$17, which is one-twelfth of the \$2.04 per \$1,000 current cost of mortality times 100 for the amount of insurance. This then leaves us with \$450 less \$21 less \$9 less \$17, or \$403. The insurer then adds one month's interest based on 4 percent—no excess interest is credited on the first \$1,000 of cash value—and the cash value at the end of the first month is \$404.32.

Exactly one month after issue, Alan pays another \$100. The 10 percent load is deducted and \$90 is credited to the cash value. The expense charge of \$30 and mortality charge of \$17 for the second month are deducted from the cash value. Finally, the balance is credited with a month's interest, resulting in a cash value at the end of the second month of \$448.78. The same transactions take place on the second monthly anniversary, the third, and so on.

At the end of the first year, the cash value would be \$901.51 based on the current ((illustrative) rates of interest and mortality. The corresponding guaranteed value would be \$827.96, or about \$74 less than the illustrative amount. Normally, there would be a greater difference between the guaranteed and illustrative values, but the cash value has earned no excess interest in the first year since it has not exceeded \$1,000.

Let's now assume that Alan is inclined to skip the \$100 premium which he normally would pay on the first policy anniversary and he "invests" it in Atlantic City. He puts the \$100 on number 35 at the roulette wheel. Lo and behold, 35 comes in and he now has \$3,600. Alan's sense of responsibility immediately returns and he goes straight to the insurer and pays a \$3,600 premium. The 10 percent is deducted, and the remaining \$3,240 goes to increase the cash value. For the thirteenth month, an \$18 mortality charge is deducted from the cash value, since Alan is now 36, and his mortality cost is slightly higher. There is no expense charge deducted from the cash value, since such charges are only applicable during the first twelve months. The cash value would be credited with interest based on 4 percent for the first \$1,000 and 11.75 percent on the amount above \$1,000, and would be \$4,155.84 at

FIGURE 4

Month	Premium	Load	Credited to Cash Value	Current Month Charge		Illustrative Cash Value End of Prior Month	End of Current Month
				Expense	Mortality		
1	\$500	\$ 50	\$450	\$21 + \$9	\$17	0	\$404.32*
2	100	10	90	30	17	\$404.32	448.78*
3	100	10	90	30	17	448.78	493.39*
4	100	10	90	30	17	493.39	538.15*
5	100	10	90	30	17	538.15	583.05*
6	100	10	90	30	17	583.05	628.10*
7	100	10	90	30	17	628.10	673.30*
8	100	10	90	30	17	673.30	718.64*
9	100	10	90	30	17	718.64	764.14*
10	100	10	90	30	17	764.14	809.78*
11	100	10	90	30	17	809.78	855.57*
12	100	10	90	30	17	855.57	901.51*
13	3600	360	3240	0	18	901.51	4155.84†
End of Second Year	—	—	—	—	—	—	4322.48†

*Includes 4% annual rate of interest only since cash value is less than \$1,000.

†Includes interest based on 4% annual rate for first \$1,000 and 11.75% on remainder.

the end of the thirteenth month. Assuming no further payments are made in the second policy year, the illustrative cash value at the end of the second year would be \$4,322.48; the corresponding guaranteed value would be \$4,010.03.

Many universal life products permit addition of a variety of riders similar to those available with current permanent insurance products—level term insurance on spouse or child; level term insurance on another insured, such as a business partner; disability waiver of either the monthly cost of insurance or the average premium paid; accidental death; guaranteed insurability; and a cost of living rider, whereby the death benefit increases annually at a fixed rate or along with changes in the consumer price index.

In the product description just given, interest rates are declared at the insurer's discretion. Because of concern over possible adverse tax rulings, some insurers guarantee that their declarations will be based on an outside interest rate index, such as thirteen-week treasury bills or the prime rate. Alan will discuss this later when dealing with taxation.

Well, that's a simplified view of how universal life works from the policyholder's perspective. Now let's consider the salesperson's position. Commissions arising from a universal life sale are generally lower than for a comparable whole life policy. On a typical whole life policy issued by an insurer not operating in New York, commissions might be something like 100 percent of the first year premium, and 5 percent of all renewal premiums. Here's how the salesperson would be compensated for Alan's policy.

Recall that the first year expense charges on the policy consist of three elements—per policy, per \$1,000 insurance, and per \$1 premium. There are corresponding commission elements as follows. The salesperson would receive \$250 for each universal life policy sold; there would also be a commission of \$2.00 per \$1,000 of insurance, or \$200; and finally, there would be a commission of 4 percent of first year premiums, or \$64 based on first year premium of \$1,600. The total first year commission would be \$514, or about 32 percent of premium. Renewal commissions would be 4 percent of premium, or \$144 based on the \$3,600 second year premium. Thus, commissions as a percentage of premiums are generally less for universal life than for traditional whole life. Nevertheless, while commissions are lower for universal life, a salesperson's compensation can be maintained by selling more policies or selling larger amounts.

Now let's consider the insurer's position. According to the *1981 Life Insurance Fact Book*, published by the American Council of Life Insurance, term insurance sold by all companies represented 41 percent of the total amount of individual ordinary life insurance sold in the U.S. in 1970, but increased to 57 percent in 1980. In addition, policy loans in 1970 totalled \$16 billion, or 7.8 percent of assets, whereas by 1980, policy loans had increased to about \$41.5 billion, or 8.6 percent of assets.

Policy lapse rates rose from 5.9 percent in 1970 to 8.1 percent in 1980. Finally, ordinary life premiums as a percent of disposable personal income declined from 3.36 percent in 1940, to 2.25 percent in 1970, to 1.62 percent in 1980. Clearly, over the last ten years and even longer, the life insurance industry has been less successful in these areas.

For at least the past few years, high interest rates available in the short-term money markets have exacerbated the problem. With money market funds yielding 17 percent and higher, there was relatively less incentive to keep money in a life insurance policy earning a low rate of interest—a maximum of 4 percent generally in nonparticipating policies and no more than around 7 percent in participating policies. Now the life insurance industry, especially the larger, established insurers, must face and cope with the sort of problems that have given rise to universal life. There are some who go so far as to say that universal life either has the potential to attract large amounts of money to the insurer, or it has the potential to replace most or all of the insurer's inforce, causing market value losses.

The highly competitive illustrations currently available from universal life products are attributable in large part to the high interest rates available on short-term investments. With its emphasis on the interest rate and its competitiveness as a savings vehicle, universal life is likely to possess certain characteristics of the investment markets, such as movement of money rapidly as the economic markets shift. Thus, the cash value accumulated in a universal life policy will probably be more transitory in nature than the cash value under a traditional whole life policy, even after recognizing the higher lapse rates and loan activity of the recent past. Consequently, most actuaries recognize that universal life cash values are most appropriately and safely invested short term. This leads to a number of difficult issues for an insurer.

Insurers have traditionally invested in fixed long-term securities and mortgages. Some of these assets may be illiquid; most are producing investment yields much lower than today's short-term yields. In today's economic climate, with the bulk of an insurer's assets earning interest at rates lower than current new money yields, each surrender or policy loan of a whole life policy results in what is essentially a market value loss for the insurer. If the volumes of loans and surrenders, already at record levels, increase even more over a short period of time, the resulting market value losses can be expected to increase the risk of insolvency.

Also, much of the insurance industry's growth and the public's confidence in us has resulted from the stability which has previously existed. The instability resulting from money moving back and forth as economic conditions change can affect an insurer's ability to operate effectively.

Ignoring the impact on existing business, universal life seems to have potential for generating substantial gains for an insurer. Expense loads correlate very closely with commissions, issue and other expenses as

incurred. Thus, there is little, if any, risk of loss on lapse due to unrecovered expenses. Also, assuming the insurer invests in appropriate short-term assets, there is little risk of market value loss on surrender and, under current conditions, there remains a margin of several percent interest for profits or contribution to surplus each year. Again, the lack of stability of cash values can result in nonstable earnings patterns, though.

Moving from the financial area to the more mundane administrative area, the flexible nature of universal life is such as to require fairly major electronic systems modification to accommodate it in an efficient and cost-effective manner. Software vendors and insurers are falling over themselves and each other trying to consummate marriages of system and product. As of the present time, I am aware of only one or two software packages which are currently operational and successfully administering all features of the universal life product. There are perhaps half a dozen software vendors targeting their systems for operation around the middle of 1982.

The universal life systems must appropriately handle premium payments of unspecified amounts, remitted on unspecified dates, and accumulating at interest rates to be determined in the future on a policy-by-policy basis. Death benefits, which can vary as to amount, must be kept track of on an individual policy basis. Policy loans must be handled separately since such amounts earn a lower rate of interest than non-loaned cash values. Term insurance costs, which are charged monthly, are on an indeterminate premium basis. Universal life appears to the policyholder to be very simple in design—you pay your money, we give you interest, we charge mortality and expense costs, etc. From an insurer's administrative point-of-view, though, it is more complex than the whole life policy, and a capable electronic system is an absolute necessity.

Now that we know what it is and how it works, let's consider universal life as it relates to the valuation and nonforfeiture laws. The new standard nonforfeiture law, approved by the NAIC in December 1980 and already enacted in about seventeen states, does not specifically address nonforfeiture requirements on universal life. It does not even define or mention universal life.

There is a catch-all section, Section 6, which allows the insurance commissioner to promulgate regulations governing the approval of any plan of such a nature that minimum values cannot be determined by the other sections of the nonforfeiture law. In other words, universal life burst on the scene so quickly, that even a very up-to-date nonforfeiture law does not directly address it. The prior nonforfeiture law dates principally to the 1940s, and even the catch-all section is not contained therein. The basic problem with the nonforfeiture law is that cash values are defined in terms of present values (prospectively), while universal life cash values are calculated in terms of an accumulation since issue (retrospectively). While most actuaries can usually demonstrate that the

prospective value equals the retrospective value, sometimes it is difficult to fit the square peg in the round hole, and universal life is a square peg, at least in terms of traditional nonforfeiture calculation.

To date, all states except New York have approved at least one insurer's universal life product. Many of these states have required an actuarial demonstration that the cash values to be calculated meet minimum standards using the following three criteria:

1. An actuarial demonstration that the retrospective accumulation is the same as the traditional nonforfeiture formula.
2. The guaranteed mortality and interest rates must be recognized and permitted by law. Then demonstrate that the use of lower mortality rates and/or higher interest rates would produce even higher cash values.
3. The excess first year expense load must be less than the statutory expense allowance. Under the pre-1980 nonforfeiture law, the statutory expense allowance is 65 percent of adjusted net premium plus \$20 per \$1,000 of insurance. Under the 1980 law, the allowance is 125 percent of the net level premium plus \$10 per \$1,000 of insurance. Now comes the \$64,000 question—what is the premium? Is it what is paid into the contract? Is it what is deducted from the cash value for term insurance costs? In order to avoid getting hung up on this question, insurers have ignored the premium-related component, and have demonstrated compliance with the per \$1,000 component.

On the valuation side, there are two basic criteria to be met:

1. The reserve must be sufficient on the valuation basis to provide future term insurance calculated using guaranteed nonforfeiture assumptions, the current cash value, and assuming that no future premium payments are to be made.
2. The expense charges must be no more than the expense allowance permitted under the commissioner's Reserve Valuation Method.

On account of its unique nature, a number of states have issued guidelines for policy approval. For example, South Carolina requires submission of sales material for approval prior to use; a statement must appear that illustrative values may materially change; the policy summary must indicate when the cash value would be exhausted based on the stipulated premium/amount relationship; a sixty-day grace period must be provided before lapse without value, with notice of impending lapse being given at least thirty days before lapse; an annual report must be given to the policyholder summarizing policy activity and results during the past year.

California has proposed guidelines which include many of the foregoing. In addition, California proposes more stringent regulation of plans where interest rate declarations are tied to an outside index, such as thirteen-week U.S. Treasury Bills. For example, the insurer must be

able to demonstrate that its investments have maturities similar to thirteen weeks, and the investment earnings thereon exceed corresponding treasury bill yields. In the absence of such a demonstration, the insurance commissioner may require the insurer to set up additional reserves.

One statutory issue which has not been a problem concerns policy loans. The typical universal life policy provides that any cash value which has been borrowed will earn only the guaranteed interest rate, usually 4 percent, rather than the current rate of 11.75 percent, while the loan bears interest at 6 percent or 8 percent. Apparently, no state has raised as an issue whether the combination of the policy loan rate plus the withheld excess interest exceeds the statutory maximum loan interest rate.

Now the most critical issue surrounding universal life—federal income tax. First, let me briefly describe the major tax issues revolving around universal life. Then, I'll discuss the current status of each of these questions and the possible implications for the industry and the policyholder. The most significant tax questions from the policyholder's point of view are:

1. Is universal life a life insurance policy, with death benefits paid free of federal income tax to the beneficiary?
2. Is the inside interest build-up of the cash value subject to yearly taxation?

The most significant tax questions from an insurer's point of view are:

1. Is the total (including excess) interest credited to the cash value deductible in determining the insurer's share of investment income, or is the excess over the contractually guaranteed rate to be considered a policy dividend?
2. Is the difference between the maximum cost of term insurance and that actually charged to be considered a policy dividend?
3. Does universal life qualify for the 818(c) adjustment to go from the commissioner's Reserve Valuation Method to net level reserves? If yes, is universal life permanent insurance and, hence, eligible for the \$21 per \$1,000 adjustment?

Considering the policyholder-related question, E. F. Hutton Life received a private letter ruling from the IRS in early 1981 stating that their "complete life" policy (which is a typical universal life policy) is life insurance, and the cash value builds up on a tax-deferred basis. This ruling has been widely disseminated throughout the industry. At this time it appears that the IRS is reconsidering its position regarding this matter.

On the insurance company issues, there have been a number of requests for rulings, but none have yet been released. The issues concerning deduction of excess interest and the difference between guaranteed and current term insurance charges are both wrapped up with other issues—in particular, excess interest on deferred annuities and the over-

all treatment of indeterminate premium policies. Few individuals expect a quick response from the IRS due to the magnitude and complexity of the issues.

Several months ago Massachusetts Mutual filed a request for a ruling on the above company issues. In particular, Massachusetts Mutual detailed two universal life policies, one participating but paying no dividends and the other nonparticipating. Their filing takes the position that both excess interest and the difference between the maximum and current term charges should be treated the same as policyholder dividends. Two other companies, Connecticut Mutual and Mutual Benefit, supported the Massachusetts Mutual effort, although the ruling was requested only by Massachusetts Mutual.

After Massachusetts Mutual filed the request for a ruling, at least two insurers (E. F. Hutton Life and Hartford Life) active in the universal life marketplace requested their own IRS rulings on the company tax issues. Not surprisingly, they both argued that both excess interest and the lower term charges are guaranteed in advance for one year at a time, and consequently should be considered guaranteed benefits for tax purposes and not policyholder dividends.

Because of concern over the possible IRS position on excess interest, several insurers have attempted to structure their contracts to minimize the tax risk. These are the indexed contracts which were briefly referred to in earlier parts of this discussion. One example of this type of policy is T-plan life, sold by Transamerica Assurance Company, a subsidiary of Occidental Life. This contract looks like most other universal life policies except that the interest rate payable is guaranteed to be the previous week's discount rate for thirteen-week U.S. Treasury Bills.

The reason for such linkage is to dissociate the determination of the excess interest rate from management discretion. Many tax experts believe that the dividing line between increased benefits and dividends may be determined by the presence or absence of such discretion. At first blush, it may seem that the insurer is going out on a limb by guaranteeing that it will credit the as-yet-unknown T-bill rate. However, note that the policy's interest rate is based on the T-bill discount rate, which is less than the corresponding effective interest rate. The discount rate is the present value on the date of issue of the interest to be paid. In numerical terms, if \$100 in interest is due one year from today and the discount rate is 14 percent, then that \$100 of interest is worth \$86 today. The \$86 amount will earn \$14 interest over the next year. If the discount rate is 14 percent, the corresponding effective annual interest rate would be just over 16¼ percent. However, the insurer is obligated to credit interest (not discount) at the 14 percent rate. Thus, at current levels of interest, there is a several percent margin for the insurer if it simply invests in T-bills. The insurer could presumably increase the margin even more by investing in good quality commercial paper.

The third tax issue for insurers concerns Section 818(c)(2) of the In-

ternal Revenue Code. This section permits approximate revaluation of reserves from a preliminary term method to the net level premium method. The key issues here are: is universal life entitled to such revaluation, and, if so, does it receive the \$21 per \$1,000 adjustment for permanent insurance or the \$5 per \$1,000 adjustment for term insurance?

In order to simplify their policy form filings with the various states, some insurers described their reserves as providing for paid-up term insurance, with no future premiums considered. This approach would rule out an 818(c)(2) election since paid-up reserves are not eligible for revaluation as they are deemed to be net-level reserves. An alternative would be to include future premiums payable for life in the reserve calculation, but assume that if they are not paid as scheduled, the scheduled premium necessary to continue the plan as permanent insurance will be recomputed and the insured so notified.

The Securities and Exchange Commission recently sent a letter to several insurers marketing universal life requesting information regarding the product and asking the insurer how it viewed the status of the product under the Securities Act of 1933. At this time it is not known what position the Securities and Exchange Commission will take regarding this product.