

**Life Insurance Product Selection, Design and Funding:  
Understanding Misleading Policy Illustrations, Alternatives to  
Policy Illustrations, and Correcting Failed Products**

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**Keynote Speaker Profile**  
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Barry D. Flagg is the inventor and founder of Veralytic®, the only patented online publisher of life insurance pricing and performance research and product suitability ratings. Veralytic is the product of his unique background as both the youngest Certified Financial Planner (CFP®) in history schooled in the fiduciary investment business, as well as a life insurance practitioner consistently ranked in the top 1% of the industry. He's a recognized expert in applying Prudent Investor principles to life insurance product selection and portfolio management and serves as subadvisor to thousands of life insurance trusts. Barry has written articles for numerous national publications and has delivered continuing education courses to attorneys, CFP®s, CPAs, and CTFAs on the management of life insurance as an asset according to established and proven asset management principles.

Barry's speaking and writing includes addressing the national conferences of the AICPA Personal Financial Planners (PFP), Ernst & Young Annual Family Office Accounting & Tax Education, Fi360, Financial Planning Association (FPA), Grant Thornton, Holland & Knight, HSBC Bank/WTAS, Notre Dame Tax Institute, the Academy of Financial Services (AFS), and many of the largest independent distributors of life insurance in the U.S. He has also been published by the ABA, AICPA, CCH, Fiduciary & Investment Risk Management Association (FIRMA) and Trust & Estates, cited by ALI/ABA reference text, guest lectured at Leadership Bootcamp for Life Insurance Stewards at West Point, Stetson Law, Texas Tech University and the Wall Street Academy, and appeared on national internet radio shows for a number of the largest insurers in the U.S.

Barry is also a Chartered Life Underwriter (CLU), Chartered Financial Consultant (ChFC) and Cum Laude graduate of the W. Paul Stillman School of Business at Seton Hall University. Barry has been on the CFP Board's Disciplinary and Ethics Commission, an adjunct faculty member of the College for Financial Planning, recognized in Who's Who in Finance and Industry and Outstanding Young Man of America, and is a member of the Society of Financial Service Professionals (SFSP), the Financial Planning Association (FPA), the National Association of Insurance and Financial Advisors (NAIFA), the Million Dollar Round Table (MDRT), and the Beta Gamma Sigma National Scholastic Honor Society.

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Bryan currently serves as President of 1759 Consulting, which provides strategic insight into planning opportunities for high net worth families, individuals, and their advisory teams.

Prior to 1759, Bryan served in various senior management positions within life insurance companies and life insurance distribution companies.

Bryan has consulted with large financial institutions in the design, development and delivery of structures and products for the premium finance and life settlement marketplaces. He also created and brought to market an international platform that provided solutions for the ultra-high net worth international client.

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Jonathan M. Forster's private wealth practice is rooted in his extensive background in life insurance, investment management and education. A trusted advisor to leaders in both industries, Jonathan provides an innovative, proprietary, four-step legacy management system to public company executives, private business owners and their respective families and family offices, designed to assist with the preservation and stewardship of wealth, as well as the development of a legacy. In addition to multi-generational business succession and family wealth planning, Jonathan also offers formation and related advice for family office structures (multi-family offices and single-family offices). He provides strategic and compliance-related representation to numerous family foundations, and strategic business-planning counsel regarding exit strategies for successful entrepreneurs and retiring public company executives. That said, Forster is also well known for his strong communication skills. Having founded and owned a training company called the American Institute for Continuing Education, Forster honed his masterful communication skills early on. He interpreted exceptionally complicated subjects in the tax area and explained them to the public along with investment and life insurance professionals. To this day, Forster serves as the chief editor and main author of a publication called the Washington Report, which reports on sophisticated tax subjects to non-tax professionals.

A former life insurance professional and educator, Jonathan continues to play a prominent role in the life insurance industry. He is sought after for his regulatory and corporate advice and is the outside general counsel for the Association of Advanced Life Underwriting. Jonathan also tracks tax related legislation and cases to produce *The WRMarketplace*, the association's newsletter.

**Life Insurance Product Selection, Design and Funding:  
Understanding Misleading Policy Illustrations, Alternatives to  
Policy Illustrations, and Correcting Failed Products  
Parts 1 and 2**

Table of Contents

	<u>Page</u>
Matrix: Life Insurance Product Types and Distinguishing Characteristics.....	10-1
Sample Report: Life Insurance Policy Analysis.....	10-3
Article: Barry Flagg - 6 Essential Ingredients to Life Insurance ADVICE (Steve Leimberg’s Estate Planning Email Newsletter Archive Message #2457).....	10-37
Example: Life Insurance Product Types and Distinguishing Characteristics.....	10-59
Article: Fiduciary Life (Inside Information, December 2017).....	10-65
Sample: Life Insurance Portfolio Performance Monitoring Report (LIPPMR).....	10-73
Example: Grantor Election Form (GEF).....	10-81
Article: Should My Client Finance Life Insurance Premiums?.....	10-83
Case Studies.....	10-93

# Life Insurance Product Types and Distinguishing Characteristics

	Term Life	Guaranteed Universal Life (GUL)	Whole Life (WL)	Current Assumption Universal Life (CAUL)	(Equity) Index Universal Life (IUL)	Variable Universal Life (VUL)
<b>Distinguishing Characteristics</b>	Lowest cost protection for a specific term of years less than life expectancy.	Premium & death benefit guaranteed for a specified period with the flexibility to change coverage duration and/or death benefit for a corresponding change in the guaranteed premium.	Fixed death benefits for a fixed premium as long as premiums are paid in cash or by dividends, but if dividends not sufficient to pay premiums, then premiums are borrowed against cash values at additional interest cost (see Policy Loan Interest Rate/Spread below).	Flexible death benefits for a flexible premium as long as Policy Cash Values are sufficient to cover cost of insurance charges (COIs) and policy expenses. Account Values are credited with interest at a rate periodically declared by the insurer commensurate with prevailing interest rates subject to a minimum guaranteed rate (e.g., 2% - 4%).	Account Values CAN BE credited with interest at a rate equal to a % of performance from an equity index (e.g., S&P500) EXCLUDING dividends subject to a minimum guaranteed rate (e.g., 0% - 2%)	Account Values either increase/decrease based on performance of self-directed mutual-fund-like Separate Accounts OR are credited with interest at a rate periodically declared by the insurer subject to a minimum guaranteed rate (e.g., 2% - 4%).
<b>Death Benefit</b>	Face Amount	Face Amount	Face Amount + Paid Up Additions (PUAs) if Dividends are used to buy PUAs & PUAs not used to pay premiums.	<b>Option A:</b> Face Amount <b>Option B:</b> Face Amount + Policy Account Value <b>Option C:</b> Face Amount + Cumulative Premiums Paid		
<b>Common Riders</b>	N/A	Maturity Extension Rider (MER) to prevent loss of coverage and/or taxable gain otherwise triggered between age 95 - 100. Accelerated Death Benefit (ADB) rider for terminal illness (i.e., life expectancy of 6-12 months). Long-Term-Care (LTC) or Chronic Illness Riders (e.g., for loss of 2 or more Activities of Daily Living or Cognitive Impairment).				
<b>Premiums</b>	Fixed for an initial term (e.g., 1, 10, or 20 yrs), but increases at each renewal.	Fixed until changed by the policyowner.	Fixed in amount, but not in the number of years due in cash.	Over-Loan Protection (OLP) Rider to prevent policy loans from causing policy lapse and the corresponding phantom taxable income on the "forgiveness" of accumulated policy loans and accumulated interest.		
<b>"Premium Call" Risk</b>	None	None, provided premiums are paid when due.	Moderate	Moderate	Higher	Depends on cash value asset allocation.
<b>Cash Value</b>	None	Cash Values are typically diminimus.	Guaranteed to equal the Face Amount at policy maturity plus Dividends used to buy PUAs.	Account Values = Premiums - COIs & Expenses + Interest/Earnings Surrender Value = Account Value - Surrender Charges		
<b>Invested Assets Underlying Policy Account Values</b>	N/A	High-grade bonds & gov't backed mortgages.	High-grade bonds & gov't backed mortgages.	High-grade bonds & gov't backed mortgages.	High-grade bonds & gov't backed mortgages.	Self-directed from among a family of mutual-fund-like Separate Accounts.
<b>Crediting/Earnings Rates</b>	N/A	N/A	Based on performance of the insurer's General Account over the long-term as declared annually to be generally commensurate with prevailing long(er)-term interest rates.	Based on performance of the insurer's General Account over the long-term as periodically declared to be generally commensurate with prevailing mid-term interest rates.	Based on the performance of an equity index (e.g., S&P500) EXCLUDING dividends subject to a max cap, a participation rate, a spread and/or a minimum guaranteed rate (e.g., 0% - 2%)	Based on the gains or losses in the selected mutual-fund-like Separate Accounts.
<b>Can Borrow Against Cash Value</b>	N/A	May lose death benefit and/or premium guarantees.	Yes	Yes	Yes	50%; Subject to Regulation U
<b>Policy Loan Interest Rate/Spread (i.e., net cost of borrowing)</b>	N/A	N/A	6%-8% or less if "direct recognition" type product.	0%-2%	0%-2%	0%-2%
<b>Cash Value at Risk if Insurer Fails</b>	N/A	Yes	Yes	Yes	Yes	No
<b>Death Benefit at Risk if Insurer Fails</b>	Yes	Yes	Yes	Yes	Yes	Yes
<b>Can be Sold Without Series 6 License</b>	Yes	Yes	Maybe	Yes	Yes	No
<b>Commission Concessions</b>	No	Sometimes	Yes	Yes	Yes	Yes
<b>Life Settlement</b>	Yes	Yes	Maybe	Yes	Yes	Yes, but with only through B/Ds supervised by FINRA.
<b>Regulated By</b>	State	State	State	State	State	FINRA and State





# Veralytic Report

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This report is presented by:

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# Table of Contents

1. Executive Summary
2. Veralytic Report Analysis
3. Illustration of Hypothetical Policy Values
4. User Guide
5. Glossary



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This Veralytic Report is based on carrier illustration and product information available at the time of preparation. It represents Veralytic's best judgment and analysis of the due care process. Due care is a complex field, and many of the areas covered are still evolving. Veralytic does not warrant the completeness of this treatment and recognizes that there is room for a difference of opinion in some areas. Furthermore, there is no definitive guidance on the tax implications of some of the specific product features found in today's life insurance policies. A qualified tax advisor should always be consulted before implementing a program in which the buying decision is based in part on anticipated tax consequences.

# Executive Summary



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# Executive Summary

## Permanent Life Insurance Product

### Policy/Illustration Under Evaluation - Sample Indexed Universal Life

This Veralytic Report was prepared for a **Sample** UL policy with a \$2,500,000 initial policy face amount and is based on the illustration of hypothetical policy values submitted for evaluation. The evaluation is intended to serve as a tool to assist financial advisors in determining the appropriateness of the policy under evaluation for a 50 year old male assumed to qualify for Standard Non-Tobacco health rates. The policy under evaluation is a Flexible UL policy with illustrated premiums shown to be paid through 10th policy year and calculated to equal the minimum premium necessary to sustain the policy face amount.

### Veralytic Appropriateness Rating - (2 stars out of 5 stars)

★★

The Veralytic Report evaluates policies on five (5) criteria to rate the appropriateness of a given product for a given planning situation using a star rating system. A **full star (★)** indicates the policy under consideration receives the highest comparative rating, a **half star (½)** indicates a median rating, and an **empty star (☆)** represents the lowest rating compared with benchmarks.

The **Sample** Indexed Universal Life is rated (2 stars out of 5 stars)

★★ for appropriateness for the illustrated plan design based on:

#### **1. Financial Strength & Claims-Paying Ability: (1/2 star)**



The insurer's financial strength and claims-paying ability ranks in the top quartile but lower than the top decile (i.e., higher than 75% but lower than 10%) of all rated insurers. While lower ratings for financial strength and claims-paying ability do not necessarily render the policy inappropriate, high ratings **and** low cost is considered more appropriate than otherwise. (Carrier Strength is reported in "Carrier Due Care" located in the lower left corner of page 2 of the Veralytic Report. This section reports the insurer's ratings and rankings by the four leading ratings services and the insurer's percentile ranking using a composite index. Ratings methods and the significance of these rankings are discussed in detail on pages 2 and 3 of Section 4, *User Guide*, of this report.)

#### **2. Cost Competitiveness: (1/2 star)**



The policy under evaluation illustrates an overall cost structure and premium that is roughly comparable to the relevant benchmark representative of an average, but competitively priced product. While an average overall cost structure and average illustrated premiums may appear less appropriate than low premiums/costs, an average premium would be more appropriate than a low premium based on a cost structure that is **not** attributable to some demonstrable operating, underwriting and/or marketing advantage. To evaluate Cost Competitiveness, the Veralytic System considers Funding Strategy and Pricing Style (reported in "Product Profile" located at the top left corner of page 1 of the Veralytic Report), as well as Premium Cost Competitiveness (reported in "Premium Comparison" located at the upper right corner of page 1 of the Veralytic Report). (The significance of Cost Competitiveness is discussed in detail on pages 3-5 of Section 4, *User Guide*, of this report.)

#### **3. Pricing Stability: (1/2 star)**



Pricing of all life insurance policies are a function of three (3) variables: 1) cost of insurance (COI) charges, 2) policy expenses, and 3) the illustrated/actual earnings rate on policy cash values. Pricing for the policy under evaluation is adequate and reasonable to the extent that cost of insurance (COI) charges and policy expenses appear to be based on actual claims and operating experience according to disclosures included in the illustration of the policy under evaluation. In addition, the pricing of the policy under evaluation is based on interest assumptions which are in line with historical returns for the asset classes corresponding to the asset types in which policy cash values are invested. However, because the insurer's retention capacity limits the degree of control over policy pricing for the policy under evaluation, pricing for this policy is somewhat vulnerable to changes in the reinsurance market. While the Veralytic Report has no way of predicting whether a policy will perform as illustrated, the Veralytic Report does consider whether the values illustrated are consistent with the insurer's historical experience, whether this experience has been fully disclosed, and how potential changes in experience might impact future policy performance. (The significance of Pricing Stability is discussed in detail on pages 5 and 6 of Section 4, *User Guide*, of this report.)

#### 4. Relative Policy Value: (0 stars)

Cash value liquidity for this policy is less adequate than the representative benchmarks. While liquidity can be less relevant in certain plan designs, policies with higher cash values and greater liquidity than relevant benchmarks are generally considered more appropriate than policies with lower cash values and more limited access to policy cash values. (Relative Cash Value comparisons are summarized in "Hypothetical Policy Cash Value Account Growth" located near the bottom of page 1 of the Veralytic Report. The significance of Relative Cash Value is discussed on pages 6 and 7 of Section 4, *User Guide*, of this report.)

#### 5. Historical Performance: (1/2 star)

The cash value allocation options for the product under evaluation are considered acceptable in that the historical net yield on the insurer's General Account Portfolio supporting illustrated policy cash values is roughly the same as the average historical net yield for all insurers (to the extent that allocating *all* policy cash values to non-equity, fixed-income-type assets is consistent with the risk/return profile of the policy owner). Insurers are required by law to invest cash values for permanent products (other than variable) predominantly in declared-rate investments such as bonds and mortgages. While the illustrated policy crediting rate may be higher or lower than the insurer's net portfolio yield at a given point in time, over time the actual policy crediting rate must correlate with the yield on the insurer's General Account Portfolio. Thus, permanent products (other than variable) whose cash values are invested in a General Account with *higher* historical net yields are generally considered more appropriate than policies whose cash values are invested in a General Account with *lower* historical net yields. (The Veralytic Report compares the illustrated net portfolio yield with average net portfolio yields for all insurers and summarizes comparisons in "Product Profile" located in the upper left corner of page 1 of the Veralytic Report. The significance of Cash Value Allocation Options is discussed on pages 7 and 8 of Section 4, *User Guide*, of this report).

All five factors contribute to appropriateness, and no single factor is sufficient to determine appropriateness. When all other appropriateness factors are equal, the policy receiving the higher appropriateness rating for any one criteria is considered more appropriate. In other words, if two policies receive similar ratings on four criteria but one is rated higher on the fifth criteria, it is considered more appropriate.

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# Veralytic Report Analysis



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# Sample Indexed Universal Life

## Product Profile

Product Rating: (2 stars out of 5 stars) ★★  
 Product Type: UL  
 Premium Type: Flexible  
 Min. Face Amount: \$25,000  
 Optimal Funding Strategy: Mixed

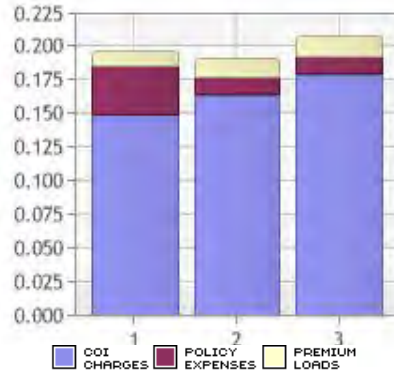
**Pricing Style:**  
 Policy pricing is a function of 3 factors: Cost of Insurance Charges (COIs), Expenses & Earnings. Product suitability is therefore categorized by the structure of and the underlying experience for these pricing components. (See The Pricing Advisor section below or at Veralytic.com for more information.)

	Max. Accum	Mixed	Min. Prem
Retail			
Institutional			
Experience-Rated			

Policy Under Evaluation	5.30%	5-yr Avg. Net Portfolio Yield *	Avg for All Policies	4.52%
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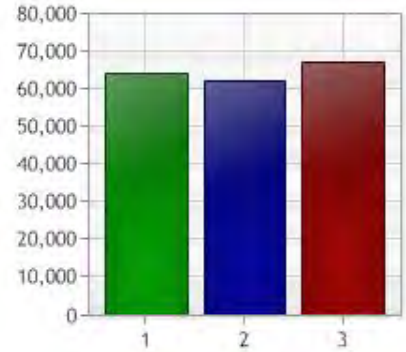
\* Source: VitalSigns<sup>2</sup>

## Policy Expense Breakdown



1. Policy Under Evaluation
2. Institutionally Priced Policies
3. Retail Policies

## Premium Comparison - Face Amt: \$2,500,000



1. Policy Under Evaluation
2. Institutionally Priced Benchmark
3. Benchmark for All Policies

Policy Expense Breakdown measures the present value cost per \$ of Death Benefit and the individual cost components, assuming identical funding amounts and funding patterns for a policy issued to a 50 year old male Non-Smoker Standard risk.

Premium Comparison calculates the minimum level annual premium required over 10 years to maintain the policy for 50 years, assuming a 6.90% average net policy earnings rate and current expense assumptions for a policy issued to a 50 year old male Non-Smoker Standard risk.

## Cost of Insurance (COI) Charges

	Policy Under Evaluation	Institutional Pricing Benchmark	Benchmark for All Policies
Weighted-Average Annual COI	\$25,380	\$27,866	\$30,402

## Policy Expenses

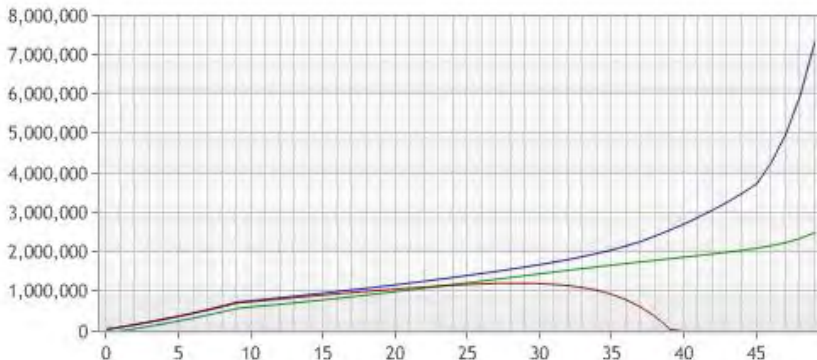
	Policy Under Evaluation	Institutional Pricing Benchmark	Benchmark for All Policies
M&E Risk %	0.00	0.00	0.00
Other %	0.00	0.00	0.00
Total %	0.00	0.00	0.00
Loan Spread %	0.00	1.00	2.00
Fixed Charges			
Per Policy Yr	\$6,088	\$2,205	\$2,205

## Premium Loads

	Policy Under Evaluation	Institutional Pricing Benchmark	Benchmark for All Policies
State Tax %	1.75	2.35	2.35
Fed DAC Tax %	1.50	1.50	1.50
Carrier % Load(s)	0.00	0.00	0.00
Sales/Service % Load(s)	2.75	3.65	3.65
Total %	6.00	7.50	7.50

## Hypothetical Policy Cash Value Account Growth

Planned Annual Premium: \$63,862



- Policy Under Evaluation
- Institutional Pricing Benchmark
- Benchmark for All Policies

The purpose of this graph is to show how different policy charges could effect policy value and death benefit. This graph is hypothetical and may not be used to predict or project actual policy performance or tax treatment.

Policy/Benchmark	Est Yr 1 Cash Value / Premium Ratio	Surrender Charge	Yrs Applied	Average Decrease %/Yr	Death Benefit @ Endowment/Maturity	Crediting Rate %	Bonus Rate %	Ultimate Rate %
Policy Under Evaluation	0.00%	100.00%	10	10.00%	\$2,525,032	6.90	0.00	6.90
Benchmark for Institutionally-Priced Policies	80.00%	0.00%	N/A	N/A	\$7,313,486	6.90	0.00	6.90
Benchmark of All Policies	0.00%	88.00%	11	8.00%	Lapse @ Y41	6.90	0.00	6.90

**Cost of Insurance (COI) Charges (Cont'd)**

Cost of Insurance charges (COIs) are deductions for the payment of claims and are typically the largest single cost factor, accounting for 75% or more of the total premium. However, because COIs vary with age of the insured, policy age, premiums, earnings, and deductions for other policy expenses, they can also be the most difficult to compare. For this reason, a weighted-average annual COI is calculated by averaging the present value of each COI charge using the Net Net Rate of Return (i.e. the rate at which cash values would otherwise have grown but for the deduction of COIs) shown above.

This weighted-average annual COI is then compared to standard industry mortality tables (75-80 S&U Male Age Nearest for current non-guaranteed COIs and 1980 CSO Male Age Nearest for guaranteed maximum COIs) to create a standardized, uniform method of comparison.

**Policy Expenses (Cont'd)**

Policy Account Value Charges include Mortality & Expense Risk (M&E) Charges and other account-value-based charges that are independent from the individual separate account funds and are, therefore, deducted from cash values at the policy level. These charges do not include Investment Advisory Fees, Fund Management Fees, nor Fund Operating Expenses that are specific to each particular separate account fund within the policy and are, therefore, deducted at the respective fund level.

**Premium Loads (Cont'd)**

All policies include deductions for State Premium Taxes, Federal DAC Taxes and charges for policy issue, administration, distribution and general operating expenses of the insurance carrier and/or the sales and servicing organization. While most policies assess charges for these expenses, either in the form of a premium load or as a flat-dollar policy expense, these expenses may be included with other policy charges and, therefore, may not be disclosed separately (shown as "N/A" when undisclosed).

**The Pricing Advisor**

Despite a confusing variety of products and terminology, insurance pricing is simple when reduced to its fundamental components. For instance, all premiums are based on three components:

- 1) death benefits claims paid, or Cost of Insurance charges (COI);
- 2) carrier and servicing organization expenses associated with policy design and administration (E); and
- 3) investment earnings (i%).

In other words, premiums will always be based on the following simple formula:  $\text{Premiums} = \text{COI} + E - i\%$ . However, different products place different emphasis on each of these pricing components. This results in products that perform differently under different funding scenarios (e.g. products with low COIs perform best in minimum-funded, defined-death-benefit applications while products with low M&E/cash-value-based expenses perform best in maximum-funded, defined-contribution-type applications).

In addition, because different groups of policyholders have different claims experience and expenses, premiums will also vary depending on the claims experience and expenses for the group being insured. The Pricing Advisor uses this simple formula to help you evaluate your client's new proposals and existing portfolios.

**Retail Pricing**

Policy pricing is a function of 3 factors: Cost of Insurance Charges (COIs), Expenses & Earnings. Product suitability is therefore categorized by the structure of and the underlying experience for these pricing components. (See The Pricing Advisor section below or at [Veralytic.com](http://Veralytic.com) for more information.)

**Institutional Pricing**

Large corporations and public companies purchase insurance differently than the average "retail" buyer. Because these large transactions and large groups of policies cost less to sell and administer, carriers typically reduce institutional cost factors to reflect volume discounts and economies of scale. While institutional products are becoming more widely available, threshold financial requirements still limit access to Institutional Pricing that offers lower premiums to only a small percent of insurance buyers. However, access to institutional pricing is becoming more widely available through purchasing groups and/or institutional risk pools.

**Experience-Rated Pricing**

In addition to the same advantage of lower expenses offered by Institutional Pricing, Experience-Rated Pricing also offers the benefit of lower COI charges. Experience-Rated products are available to only a selective pool of qualified companies and qualified individuals. Experience-Rated products are priced for the superior claims experience of professionals, business executives and owners, and high net worth individuals. Because this group enjoys healthier lifestyles and better health care, they live longer. As a result, this group experiences lower mortality rates, and products priced for this market generally have lower COI charges than products sold to retail and institutional markets.

**Carrier Due Care**

Financial Strength & Claims-Paying Ability Ratings (alpha order)		Watch List
AM Best	A (3 of 15)	n/a
Fitch	0 (0 of 24)	n/a
Moody's	0 (0 of 21)	n/a
Standard & Poor's	A (6 of 20)	n/a
Percentile Ranking	79%	
<b>Retention Limit:</b>		
Single Life:	\$1,000,000	

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2 Source Vital Signs by EbixExchange © 1996-2013 Ebix, Inc. All Rights Reserved. The information, data, analyses and opinions contained herein (1) include the confidential and proprietary information of Ebix, Inc., (2) may not be copied or redistributed, (3) do not constitute investment advice offered by Ebix, Inc., (4) are provided solely for informational purposes, and (5) are not warranted to be correct, complete or accurate. Ebix, Inc. shall not be responsible for any trading decisions, damages or other losses resulting from or related to this information, data, analyses or opinions or their use.



# Illustration of Hypothetical Policy Values



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This Veralytic Report is based on carrier illustration and product information available at the time of preparation. It represents Veralytic's best judgment and analysis of the due care process. Due care is a complex field, and many of the areas covered are still evolving. Veralytic does not warrant the completeness of this treatment and recognizes that there is room for a difference of opinion in some areas. Furthermore, there is no definitive guidance on the tax implications of some of the specific product features found in today's life insurance policies. A qualified tax advisor should always be consulted before implementing a program in which the buying decision is based in part on anticipated tax consequences.

### Sample Ledger Illustration

Assuming Current Charges and a Current Rate of 6.90%  
 Initial Death Benefit: \$2,500,000  
 Initial Annual Planned Premium: \$63,862

Policy Year	EOY Age	Planned Premium	Net Outlay	Account Value	Net Surrender Value	Net Death Benefit
1	51	63,862	63,862	45,823	0	2,500,000
2	52	63,862	63,862	94,077	16,902	2,500,000
3	53	63,862	63,862	144,756	76,156	2,500,000
4	54	63,862	63,862	198,163	138,138	2,500,000
5	55	63,862	63,862	254,646	203,196	2,500,000
6	56	63,862	63,862	314,532	271,657	2,500,000
7	57	63,862	63,862	378,090	343,790	2,500,000
8	58	63,862	63,862	445,550	419,825	2,500,000
9	59	63,862	63,862	517,129	499,979	2,500,000
10	60	63,862	63,862	592,963	584,388	2,500,000
Totals:		638,621	638,621			
11	61	0	0	624,794	624,794	2,500,000
12	62	0	0	658,097	658,097	2,500,000
13	63	0	0	692,698	692,698	2,500,000
14	64	0	0	728,316	728,316	2,500,000
15	65	0	0	765,139	765,139	2,500,000
16	66	0	0	803,039	803,039	2,500,000
17	67	0	0	842,293	842,293	2,500,000
18	68	0	0	882,979	882,979	2,500,000
19	69	0	0	924,942	924,942	2,500,000
20	70	0	0	968,375	968,375	2,500,000
Totals:		638,621	638,621			
21	71	0	0	1,012,633	1,012,633	2,500,000
22	72	0	0	1,057,264	1,057,264	2,500,000
23	73	0	0	1,101,987	1,101,987	2,500,000
24	74	0	0	1,146,569	1,146,569	2,500,000
25	75	0	0	1,190,926	1,190,926	2,500,000
26	76	0	0	1,235,793	1,235,793	2,500,000
27	77	0	0	1,281,286	1,281,286	2,500,000
28	78	0	0	1,327,151	1,327,151	2,500,000
29	79	0	0	1,373,091	1,373,091	2,500,000
30	80	0	0	1,418,941	1,418,941	2,500,000
Totals:		638,621	638,621			

Illustration not complete without footnote and compliance pages, which have been intentionally omitted for space considerations.

### Sample Ledger Illustration

Assuming Current Charges and a Current Rate of 6.90%

Initial Death Benefit: \$2,500,000

Initial Annual Planned Premium: \$63,862

Policy Year	EOY Age	Planned Premium	Net Outlay	Account Value	Net Surrender Value	Net Death Benefit
31	81	0	0	1,464,551	1,464,551	2,500,000
32	82	0	0	1,509,499	1,509,499	2,500,000
33	83	0	0	1,553,841	1,553,841	2,500,000
34	84	0	0	1,597,933	1,597,933	2,500,000
35	85	0	0	1,641,193	1,641,193	2,500,000
36	86	0	0	1,683,898	1,683,898	2,500,000
37	87	0	0	1,726,010	1,726,010	2,500,000
38	88	0	0	1,765,945	1,765,945	2,500,000
39	89	0	0	1,805,311	1,805,311	2,500,000
40	90	0	0	1,844,508	1,844,508	2,500,000
Totals:		638,621	638,621			
41	91	0	0	1,885,088	1,885,088	2,500,000
42	92	0	0	1,925,855	1,925,855	2,500,000
43	93	0	0	1,968,120	1,968,120	2,500,000
44	94	0	0	2,011,697	2,011,697	2,500,000
45	95	0	0	2,057,877	2,057,877	2,500,000
46	96	0	0	2,110,891	2,110,891	2,500,000
47	97	0	0	2,175,223	2,175,223	2,500,000
48	98	0	0	2,254,740	2,254,740	2,500,000
49	99	0	0	2,358,872	2,358,872	2,500,000
50	100	0	0	2,500,032	2,500,032	2,525,032
Totals:		638,621	638,621			

Illustration not complete without footnote and compliance pages, which have been intentionally omitted for space considerations.

# User Guide



Nothing contained in this Veralytic Report is to be considered as a rendering of legal, tax or investment advice for specific cases, and readers are responsible for obtaining such advice from their own legal, tax and investment counsel. Accordingly, no representations or warranties are made by anyone, including, without limitation, Veralytic and anyone engaged in the preparation and distribution of this report, as to the validity or effectiveness of the legal or tax conclusions, analysis, opinions, and planning ideas expressed in this Veralytic Report. Any and all liability whatsoever that may arise in connection with anything contained herein is hereby disclaimed. This Veralytic Report is intended for educational and informational purposes only.

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This Veralytic Report is not valid without all constituent pages, including the cover page and section pages bearing important notes and footnotes clarifying its proper use.

## Veralytic Star Rating

The suitability of permanent life insurance products depends principally upon the following five factors:

- Insurer Financial Strength
- Cost Competitiveness
- Pricing Stability
- Policy Liquidity
- Historical Performance

The Veralytic Research Platform evaluates policies on these five criteria and rates them compared to industry benchmarks (see more on benchmarks at the top of page 4-2 in this section) using a star rating system. A ★ (full star) indicates the policy under consideration receives the highest comparative rating, a ☆ (half star) indicates a median rating, and an ☆ (empty star) represents the lowest rating compared with benchmarks.

All five factors contribute to suitability, and no single factor is sufficient to determine suitability. While cost is clearly important, buying insurance is different than other consumer purchases. With many consumer products, price is often directly related to quality, and the higher the price the better the quality, durability, or service. For instance, the higher the financial strength of a bond issuer, the lower the interest rate (i.e., the lower the price the issuer must pay to attract investors, and the lower the market value of the bond on the open market). However, this direct correlation between policy cost and quality doesn't necessarily exist in life insurance products. For example, higher carrier ratings, which indicate greater financial strength and claims-paying ability, don't necessarily dictate higher costs because a number of other factors influence pricing (discussed further under Cost Competitiveness section below). However, when two policies have the same cost, but one of the insurers has higher carrier strength ratings, the Veralytic Reports consider the product offered by the more highly rated carrier more suitable.

For permanent life insurance, pricing suitability depends upon a number of factors, and the lowest premium may not always offer the best value. Fortunately, despite a confusing variety of products and terminology, insurance pricing is simple when reduced to its three fundamental components:

- Cost of insurance charges (COI) for death benefit claims
- Carrier and servicing organization expenses (E) for policy design, underwriting, and administration
- Investment gains and/or interest income (i%) credited to policy cash values in excess of COIs and E

In other words, premiums are always based on the following formula in minimum-premium defined-death-benefit policy designs, and policy performance is always based on the following formula in maximum-accumulation defined-contribution policy designs:

$$\text{Premiums/Performance} = \text{Cost-of-Insurance Charges (COI)} + \text{Policy Expenses (E)} - \text{Policy Interest/Earnings (i\%)}$$

As such, the Veralytic Research Platform uses this simple formula to evaluate the pricing suitability of either proposed coverages and/or inforce policies, as follows. First, the system separates policy costs into either cost of insurance charges (COIs) shown below left, and policy expenses (E) shown below middle and below right. It then groups expenses by their nature into the only three (3) ways that insurers calculate and collect policy expenses, namely 1) fixed administration charges (FAEs), 2) cash-value-based "wrap fees" (e.g., M&Es), and 3) premium loads. The system then "normalizes" cost of insurance charges and expenses to account for differences in amounts and timing of the different charges in different policies for easy comparison (see discussion of each pricing component in the Pricing Competitiveness section). This "normalizing" of varying policy charges computes a single value for each pricing component by adjusting for differences in timing at the rate of interest/earnings at which the policy cash values would otherwise grow, but for the deduction of the given charge(s). The Veralytic Research Platform then compare these "normalized" values with benchmarks for each pricing component in the tables located in the middle of page 2-1 of the Veralytic Report, an example of which is also shown below.

Cost of Insurance (COI) Charges				Policy Expenses				Premium Loads			
Policy Under Evaluation	Institutional Pricing Benchmark	Benchmark for All Policies	% of Cash Value	Policy Under Evaluation	Institutional Pricing Benchmark	Benchmark for All Policies	% of Premium	Policy Under Evaluation	Institutional Pricing Benchmark	Benchmark for All Policies	
Weighted-Average Annual COI	\$13,166	\$12,940	\$14,734	M&E Risk %	0.05	0.55	0.60	State Tax %	2.35	2.35	2.35
				Other %	0.00	0.00	0.00	Fed DAC Tax %	1.50	1.50	1.50
				Total %	0.05	0.55	0.60	Carrier % Load(s):	0.00	0.00	0.00
				Loan Spread %	0.75	1.00	2.00	Sales/Service % Load(s):	3.15	3.65	3.65
				Fixed Charges				Total %	7.00	7.50	7.50
				Per Policy Yr	\$2,529	\$1,728	\$1,728				

The practice of benchmarking is well-established and quite common in the financial services industry where the performance of a financial instrument is frequently compared to a standard, independent point of reference. For instance, to determine the appropriateness of a given mutual fund selection, the performance of that mutual fund is often compared with the Dow Jones Industrial Average, the S&P 500, the NASDAQ, or the Wilshire 5000. Veralytic Benchmarks are similarly used to compare the pricing and performance of a given life insurance product, and can thus be used to determine appropriateness of a given life insurance policy selection. Veralytic Benchmarks are derived from industry standard mortality tables (see Society of Actuaries 75-80 Basic Select & Ultimate Gender Distinct Mortality Tables at [www.soa.org](http://www.soa.org)), industry aggregate expense ratios (see Society of Actuaries Generally Recognized Expense Table for 2001 also at [www.soa.org](http://www.soa.org)), and generally accepted actuarial principals. Like other benchmarks, they do not reflect the mathematical average of all products, but instead illustrate example policy pricing and performance intended as representative of an "average product". In other words, because Veralytic Benchmarks were designed by actuaries to be intentionally average, based on "average" premium loads, "average" policy administration expenses, "average" cost of insurance charges, and "average" cash-value-based "wrap-fees", practitioners can expect to find products which offer lower premium loads, and/or lower policy administration expenses, and/or lower cost of insurance charges and/or lower cash value fees, and therefore will illustrate a lower premium, higher cash values, and higher death benefits, or some combination thereof. Conversely, practitioners can also expect to find other products which offer premium loads, policy administration expenses, cost of insurance charges and/or cash value fees which are higher than Veralytic Benchmarks, and these other products will, therefore, illustrate a higher premium, lower cash values, and lower death benefits, or some combination thereof.

Veralytic Reports use such actuarially determined representative costs and performance levels for products of a specified product type for comparison purposes. Benchmarks for cost of insurance charges (COIs), fixed administration expenses (FAEs), premium loads and cash-value-based "wrap fees" (e.g., M&Es) are the result of both the above-mentioned industry standard mortality tables and expense ratios, generally accepted actuarial principles and actuarial study of representative sample populations of similar type products. Mortality and expense pricing data for policies with face amounts of \$1 million or more are used to generate benchmarks for products priced for institutional markets, and benchmarks for products priced for retail markets are derived from "industry aggregate" mortality and expense pricing data for all policies. These actuarially derived benchmark pricing components are then used to generate a hypothetical policy profile for comparison to the policy under consideration.

After identifying those policies offering the most suitable cost structure that are available from the insurers considered to have the greatest relative financial strength and claims-paying ability, the system then considers the stability of policy pricing as it relates to the ability for a given insurer to deliver actual policy performance that corresponds to illustrated policy pricing. Lastly, the system compares the liquidity of cash value accumulations over time, and evaluates the number, breadth, performance, and cost-effectiveness of underlying cash value allocation options. The results of these comparisons are reported in the Veralytic Report for each individual product. To help you use the Veralytic Report to understand the suitability of the policy under consideration, the five criteria and the significance of the star ratings for each are explained in the following sections.

## Financial Strength & Claims-Paying Ability

The financial strength and claims paying ability of an insurer is the first measure of suitability for life insurance products, particularly permanent life insurance products. Veralytic Reports evaluate insurers based on their relative financial strength and claims-paying ability and assign a ★(full star) to insurers ranking in the top decile (top 10% percent), a ☆(half star) to insurers ranking the top quartile (top 25% percent), and an ☆(empty star) to insurers ranking in the lower three quartiles of all insurers. Given that insurance is most simply defined as an agreement for the payment of a premium today in exchange for payment of a claim at some future point, the more time between policy inception and the expected claim date, the more important the durable financial strength and long-range claims-paying ability. However, the insurer’s financial strength and claims-paying ability does not in any way affect the performance of the underlying investment accounts and, therefore, cannot be considered a measure of future investment performance.

For the policy under consideration, financial strength and claims-paying ability of the issuing insurer is reported in “Carrier Due Care” (sample shown to the right) located in the lower left corner of page 2-2 of the Veralytic Report for each individual product, and includes ratings prepared and published by nationally recognized ratings services like AM Best, Fitch, Moody’s, and Standard & Poor’s. In addition, because different ratings services use different scales (e.g., one service grades insurers “A” through “F,” others use a “AAA” system similar to a bond rating scale, and still others use “A+.”), and because different rating services define rating categories differently (e.g., an “A+” rating from Best is the second highest possible rating while an “A+” rating from Standard & Poor’s or Fitch represents a relatively less attractive fifth highest rating), Veralytic Reports reconcile these inconsistencies by comparing the relative financial strength and claims-paying ability of a particular insurer to all other insurers, and convert otherwise inconsistent ratings scales are converted to percentile rankings.

Carrier Due Care <sup>2</sup>			
Financial Strength & Claims-Paying Ability Ratings (alpha order)			Watch List
AM Best	A++	(1 of 15)	n/a
Fitch	AA	(3 of 24)	n/a
Moody’s	Aa3	(4 of 21)	n/a
Standard & Poor’s	AA	(3 of 20)	n/a
Percentile Ranking		94%	
<b>Retention Limit:</b>			
Single Life:		\$10,000,000	

VitalSigns, a service offered by EbixExchange (which must be separately licensed for use in Veralytic Reports), compares carrier ratings from the five leading rating services, determines relative rankings, and converts rankings to percentiles. VitalSigns prepares and publishes a composite index (Comdex) derived by averaging insurers’ percentile rankings. That is, Comdex is not a rating itself but rather is a composite of all the ratings an insurer has received converted to percentiles. Comdex reports an insurer’s standing on a scale from 1 to 100 relative to all other insurers that have been rated by the leading ratings services with 100 being the strongest ranking and 1 being the weakest ranking. Veralytic Reports use the inverse of the Comdex in assigning a star value for the product under evaluation (i.e., a Comdex of 100 ranks that insurer in the top-1% of all insurers for financial strength and claims-paying ability).

While the insurer’s financial strength and claims-paying ability does not affect investment performance, it is particularly important for the following three reasons:

- **Lengthy Period of Risk Exposure:** The duration of time between the policy effective date and the ultimate date of claim is typically longer than that for any other form of insurance. Consequently, the opportunity for change adversely impacting the insurer of a given permanent life insurance product is greater than that for any other form of insurance. With this greater exposure to uncertainty, the importance of durable financial strength and long-range claims-paying ability is greatest for permanent life insurance products.
- **Front-End/Back-End Fees/Charges:** Permanent life insurance products often include up-front “set-up” fees (commonly referred to as “Policy Issue Fees”) and/or back-end cancellation fees (commonly referred to as surrender charges). Changing products or insurers in response to an unacceptable deterioration in financial strength and claims-paying ability can be uneconomical due to these previously-paid up-front fees and may be difficult or costly due to these back-end surrender charges.
- **Continued Health & Insurability:** The ability to change life insurance products or insurers is conditioned on continued health and insurability. While the probability of death is small at the time a policy is issued, the likelihood of a change in health that would adversely impact the pricing of a policy is considerably greater. While insurers *cannot* change the pricing of an existing policy in response to a change in health, such a change in health will impact the ability to change policies/insurers in response to an unacceptable deterioration in financial strength and claims-paying ability.

Thus, while a product underwritten by an insurer considered to have greater financial strength and claims-paying ability is not, in and of itself, a more suitable product, products issued by insurers with superior anticipated ability to meet future claims obligations are considered more suitable than otherwise. While no rating method is guaranteed to predict which insurers will best meet future claims, ratings of current financial strength and claims-paying ability are the accepted best gauge of insurer strength. As such, Veralytic Reports use the mathematical distribution of all rated insurers as an objective measure to support accurate comparisons among insurers, and assign either a ★(full star), a ☆(half star), or an ☆(empty star) for the suitability of an insurer’s financial strength and claims-paying ability.

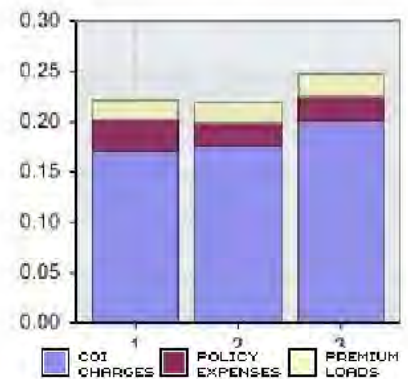
## Cost Competitiveness

The cost competitiveness of a given policy is an obvious determinant of suitability. In addition, the appropriateness of a given policy's pricing makeup to a given situation can have substantial influence over the cost competitiveness, and, therefore, is also a determinant of suitability. Thus, Veralytic Reports consider both policy costs as to cost of insurance charges (COIs), fixed administration expenses (FAEs), cash-value-based "wrap fees" (e.g., M&Es) and premium loads, as well as the construction of those to determine the policy's pricing style and optimal funding strategy (see Pricing Style in this section below). Veralytic Reports show the policy's cost competitiveness by comparing both individual and aggregate policy costs with industry benchmarks representative of average costs for all other policies in the peer group (see more on benchmarks at the top of page 4-2 in this section), and assign a ★ (full star) for policies whose cost competitiveness is better than average, a ★ (half star) for policies whose cost competitiveness is roughly the same as the average, and an ☆ (empty star) for policies whose pricing is less competitive than average and/or whose pricing makeup is inappropriate to the given situation.

The Veralytic Research Platform measures policy costs by calculating the present value policy of all policy costs per \$1.00 of death benefit over the illustrated policy holding period, and graphically displays the composition of policy costs in the Policy Expense Breakdown located at the top center of page 2-1 of the Veralytic Report for each individual product, an example of which is shown below right. As such, the Policy Expense Breakdown provides the practitioner with an understanding of both how each pricing component compares to industry benchmarks, as well as the relative impact on overall policy pricing of the individual pricing components as to cost of insurance charges (COIs), fixed administration expenses (FAEs), premium loads and cash-value-based "wrap fees" (e.g., M&Es) for the policy under evaluation, each of which are discussed in greater detail below:

**Cost of Insurance Charges (COIs)** – Whether disclosed or not, all policy issues are priced for expected cost of insurance charges or COIs. COIs are deductions from permanent life insurance policies to cover anticipated payments by the insurer for death claims. As with most types of insurance, claims are, and arguably should be, the largest single cost factor of any insurance policy (If claims are not the largest single cost factor, then is the product really insurance against the risk of death, or something else?). With life insurance, COIs typically account for about 75% of total cost, and, as expected, the higher the claims, the higher the COIs and the higher the premiums. COI charges are calculated year-by-year as the result of the policy death benefit (see net amount at risk below) multiplied times a COI rate provided by the insurance company for each age corresponding to each policy year for each product. These deductions are much like term life insurance premiums in that they are predominantly for claims paid during a given period (typically 1 year). For this reason, COIs are frequently referred to as the pure "risk" portion of the premium, reimbursing the insurance company for the risk associated with paying the death benefit. Because the risk of death increases with age, so do the COIs.

Policy Expense Breakdown



1. Policy Under Evaluation
2. Institutionally Priced Policies
3. Retail Policies

COIS

For example, assume an insurance company provides permanent life insurance for a group of 1,000 policyholders whom all are insured for \$100,000 and three (3) insureds out of the group of 1,000 die in a given year. The insurance company pays \$300,000 to the beneficiaries of those three insureds. The insurance company must therefore collect \$300 from each policy owner over the course of the period in order to pay this \$300,000 in claims (i.e. 1,000 policyholders times \$300=\$300,000 in death claims paid). In this case, the COI Rate would equal \$3.00 per \$1,000 of death benefit (i.e. each insured paid \$3.00 multiplied times 100 for each \$1,000 of death benefit). Of course, as the average age of the population of 1,000 in the group ages, then the risk of more deaths increases. For example, the next year, all insureds are a year older, and because the probability of death increases with age, we assume that four (4) insureds out of population of 1,000 die in this next year (for the sake of simplicity, we will assume that the insurance company sold three (3) new \$100,000 policies to replace the three \$100,000 policies removed from our pool by the three deaths in the prior year). The insurance company will pay \$400,000 to the beneficiaries of those four insureds. The insurance company must collect \$400 from each policy owner over the course of the period in order to pay this \$400,000 in claims (i.e. 1,000 policyholders times \$400=\$400,000 in death claims paid/to be paid). In this case, the COI Rate would equal \$4.00 per \$1,000 of death benefit (i.e. each insured paid \$4.00 multiplied times 100 for each \$1,000 of death benefit).

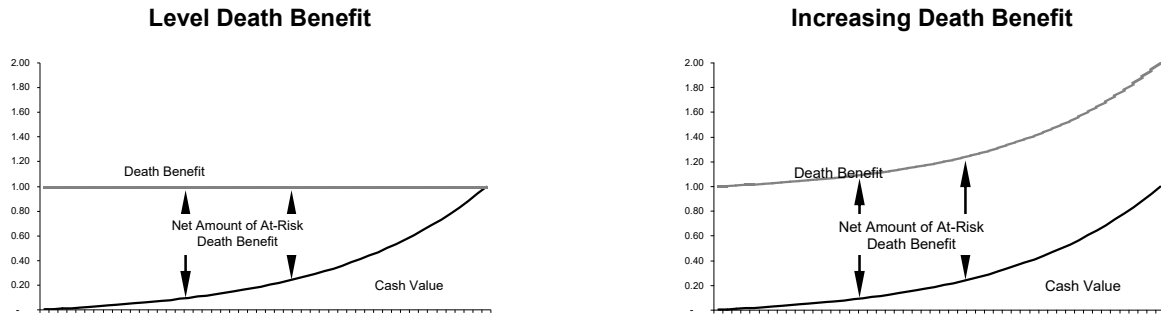
This example also assumes the insurance company collects only the exact amount necessary to pay these claims. However, in reality, the insurance company must also collect a profit to remain in business. Actual COIs in this example would, therefore, be slightly higher to cover anticipated claims, but then also to provide a profit to the insurance company providing the insurance and bearing the risk. In addition, some insurers "load" the COIs to cover other policy expenses that are not disclosed elsewhere. For instance, some policies are marketed as "no-load" or "low-load" policies, and as such do not disclose certain policy expenses or loads. The expenses or loads that are typically "hidden" are sales loads, and other premium based loads. However, because certain premium based loads must be paid (e.g. state premium taxes, federal deferred acquisition costs (DAC) taxes, and the cost to distribute the policies), some insurers "hide" these costs inside "loaded" COIs.



COIS

As mentioned above, in all cases, these COIs are calculated each policy year as the result of the policy "net at risk" death benefit multiplied times a COI Rate provided by the insurance company for each age corresponding to each policy year for each product. This "net at risk" death benefit is that portion of the total death benefit in excess of any policy cash value and is thus the inverse of the cash value (e.g., the higher the cash value of the policy, the lower the net at risk amount of death benefit to the insurer).

For example, to the extent policy cash values increase over time, this net-at-risk death benefit will decline from year to year in a level-death-benefit policy design, or will remain level in an increasing-death-benefit policy design, as shown below:



While different policies can calculate the "net at risk" death benefit differently, this Net Amount at Risk (NAR) in any given year can be generally calculated as follows:

$$\text{Net Amount at Risk} = \text{Policy Death Benefit} - \text{Policy Cash Value}$$

Because COIs are calculated on the NAR, and because COIs increase geometrically with age as discussed above, the NAR is a significant factor for the pricing and performance of any policy holding. For instance, COI costs are minimized when cash values are nearly equal to the policy death benefit even at the older ages when COI rates are at their highest. However, because policy cash values are "confiscated" by the insurer upon death, any COI cost savings associated with high cash values and a corresponding low NAR must be measured against the present value "cost" of forfeiting future policy cash values upon death. Either way, COIs are characteristically the largest policy expense, and are always a function of the COI rate provided by the insurance company for each year of a given policy holding, the net amount at risk in each of those years of that policy holding, and the design of the policy death benefit (i.e. level death benefit or increasing death benefit) for that policy holding.

**Fixed Administration Expense (FAE)** – FAEs are typically charged for expenses related to actuarial design, underwriting and new business processing, and service and administration, and are calculated as some fixed amount set at the time of policy issued either as a flat monthly charge (e.g. \$10.00 a month), or in relation to the originally issued policy face amount (e.g. \$1.00 per \$1,000 of policy face amount). While this charge is fixed in amount at the time of policy issued, it can vary from year to year by a predetermined schedule (e.g. \$10.00 a month and \$1.00 per \$1,000 of policy face amount during the first 10 policy years, and \$5.00 a month and \$0.00 per \$1,000 of policy face amount thereafter).

In addition, FAEs can also include contingent or back-end policy surrender charges that are deducted from the policy cash account value upon surrender or cancellation/termination of the policy. These surrender charges are calculated in relation to the initially issued policy face amount and can be as much as 100% or more of the planned annual premium for policy issues available to the general public at large (i.e. policies commonly referred to as "Retail Policies"), or can be less or even 0% for policies purchased in larger volumes (i.e. frequently referred to as "Institutionally Priced Policies"). In either case, this surrender charge typically remains level for an initial period of years (e.g. 5 years), then reduces to \$0 over a following period of years (e.g. policy years 6 through 10 or 6 through 15).

FAES

**Premium Loads** – Premium loads are calculated as a percent of premiums paid in a given year and typically range between 0% and 35%. Premium-based charges customarily cover state premium taxes that average 2.50%, DAC taxes averaging 1.5%, and Sales Loads/Expenses ranging between 0% and 30%. In addition, while state premium taxes and DAC taxes are generally calculated by the respective government agencies as a percent of premium, and while insurance companies must certainly pay these taxes, insurance companies are not required to assess the charge as a percent of premium. As such, some insurance companies charge no (i.e. 0%) premium charges, and collect state and federal taxes from other charges within the policy (usually COIs).

Premium-based charges can also vary depending on either the policy year in which a premium is paid or the level of the premium paid into a given policy. For instance, a higher premium load may be assessed in the early policy years to recover up-front expenses related to underwriting, issue and distribution of a given policy. After these up-front expenses have been amortized (frequently over a period of ten policy years), premium loads are then often reduced to cover the relatively lower policy owner service and policy administration expenses. In addition, a higher premium load may be charged on actual premiums paid up to a "Base Policy Premium" or "Target Premium" level, while a lower premium load may be charged on actual premiums paid in excess of this "Base Policy Premium" or "Target Premium" amount. This "Base Policy Premium" or "Target Premium" is calculated by actuaries to mature the death benefit as permanent regardless of the age of death of the insured and based on expectation COIs, expenses and interest/earnings. As such, this "Base Policy Premium" or "Target Premium" is analogous to the "insurance premium" (i.e. that premium typically paid to maintain insurance coverage).

Premium amounts paid into the policy in excess of this "Base Policy Premium" or "Target Premium" can, therefore, be viewed as "excess premium" above and beyond that which required to support a given insurance death benefit. "Excess premiums" are typically paid to either create a cash value reserve which can be used to pre-pay future premiums, COIs and policy expenses (i.e., the minimum planned premium paid for a limited duration to support a defined death benefit), and/or to accumulate wealth in the form of policy cash values that benefit from preferred federal income tax treatment and special protection from the claims of creditors under state law (i.e., under a defined-contribution maximum-accumulation plan design). As such, premiums paid up to the "insurance premium" are typically subjected to "insurance loads" to cover policy expenses unique to the insurance component of the policy, while "excess premiums" are typically subjected to a lower "investment-like loads" on those monies contributed toward cash values accumulations. In either case, Veralytic Reports calculate the blended premium load for easy comparison to industry benchmarks and/or peer group products.

**Cash-Value-Based "Wrap Fees"** – Cash-value-based "wrap fees" are insurance fees charged as a percent of policy account values (e.g., like M&Es found in variable products) similar to Fund Management Fees (FMEs) that are also charged as a percent of assets under management. However, these cash-value-based *insurance fees* are specific to the policy, and separate from and in addition to *investment fees*. The most common policy specific cash-value-based fee is the M&E charge intended to cover the risks assumed by the insurance company that actual cost of insurance charges and/or actual expense charges will be greater than expected. Some products can also include policy specific cash-value-based fees in addition to the M&E, both of which can vary depending on the year of the policy (e.g. 1.00% of cash values during the first 10 policy years, and 0.5% of cash values thereafter), and/or the amount of the cash value (e.g. 1.00% of cash values up to \$25,000, and 0.5% of cash values above \$25,000), and in either case typically range from 0% to 100 bps (1.00%).

Because these cash-value-based charges are specific to the policy, without regard to the underlying general account investment portfolio or mutual-fund-like separate account funds, Veralytic Reports consider such cash-value-based *insurance fees* when reporting on the suitability of the policy under evaluation (PUE). This treatment is in contrast to fund-specific *investment fees*, which are a function of the underlying investment portfolio or separate account funds, which may or may not be disclosed, which are different for different separate accounts funds within the same product, and which usually change within the same policy over time with changes in asset allocations of invested assets underlying policy cash values. As such, Veralytic Reports do not consider fund specific investment fees as a policy cost, and instead consider such fund specific investment expenses as part of the evaluation of cash value investment performance (see further discussion of fund specific investment expenses under Historical Performance section).

Because some products deduct cash-value-based insurance expenses at the policy level and thus disclose both the dollar amount as well as the percentage rate of the charges, while other products deduct cash-value-based insurance expenses at the separate account level only disclosing the percentage rate of the charges and *not* generally disclosing the dollar amount of the policy expense, Veralytic Reports account for cash-value-based insurance charges by deducting the cash-value-based "wrap fee" percentage rate from the policy interest/earnings rate. In other words, Veralytic Reports account for all policy expenses in the manner in which they are disclosed by first calculating the rate by which cash values would otherwise grown but for the deduction of this and all other policy expense, and then use this rate as the present value rate to calculate the present value of all other policy costs (see discussion of policy interest/earnings in the Pricing Stability section).

**Pricing Style** – The manner in which cost of insurance charges (COIs), fixed administration expenses (FAEs), premium loads and cash-value-based “wrap fees” are constructed and calculated in a given policy and the market for which a given policy is priced determine the suitability of a given product to a given situation. The Veralytic Report Pricing Style Box, therefore, provides practitioners with both the optimal funding strategy (i.e., minimum premium/defined-death-benefit, maximum accumulation/defined- contribution, or some combination of the two) and the target market (i.e., retail, institutional, or experience-rated) for which the policy under evaluation (PUE) is priced, located at the top left corner of page 2-1 of the Veralytic Report for each individual product (sample shown below right).

The optimal funding strategy for the product under evaluation is determined by comparing the relative impact on overall policy pricing of the individual pricing components to assist practitioners in identifying the highest-and-best use for a given product and/or to explain why a product from an insurer with a good reputation may appear more costly than other products. As such, the Pricing Style Box does not indicate the relative competitiveness of policy pricing, but instead indicates the planning circumstances in which the construction of policy costs will perform optimally, as described below:

Funding Strategy

**Minimum Premium/Defined-Death-Benefit** – In defined-death-benefit planning designs (i.e., minimum premium), the desired amount of policy death benefit is specified with the premium as the variable that is calculated in a fashion to determine the minimum premium needed to fund the policy for the planned duration of coverage. Policies with low cost of insurance (COI) charges and low fixed expenses (i.e., low fixed dollar expenses) perform optimally in defined-death-benefit plan designs and minimum premium funding strategies even when premium loads and cash-value-based fees (i.e., percentage rate expenses) are relatively high. As with other forms of insurance, death claims (COIs) are the largest cost factor, and are fixed for the defined death benefit (i.e., remain materially the same for a given amount of insurance without regard to the amount of the premium). In addition, because premiums and cash values are, by definition, relatively low under defined-death-benefit, minimum premium plan designs, even relatively high percentage rate expenses applied to the relatively low premium result in a relatively low dollar amount, and thus have less influence on policy performance. As such, policies with low COIs and other fixed charges are most suitable where the planning objective is to achieve the lowest possible premium. It is important to also note that a minimum premium plan design may require more premium than the originally illustrated “minimum premium” in response to negative policy performance and/or increased policy costs and to prevent the policy from lapsing (see policy interest/earnings discussion under Pricing Stability).

	Max. Accum	Mixed	Min. Prem
Retail			
Institutional			
Experience-Rated			

**Maximum Accumulation/Defined-Contribution** – On the other hand, in defined- contribution designs (i.e., maximum accumulation), the desired premium or contribution to the policy is specified with the policy death benefit as the variable that is calculated in a fashion to determine the minimum policy face amount required under prescribed guidelines. Because permanent life insurance policies are granted certain tax benefits, the Federal Government prescribes a relationship between premium contributions and policy death benefits that is required to qualify for and limits these tax benefits under the Definition of Life Insurance (DOLI) and Modified Endowment Contract (MEC) rules. Reducing policy death benefits to the minimum allowable amount needed to accommodate the desired premium over the planned premium payment period under these rules has the effect of reducing the Net Amount at Risk (see discussion of Net Amount at Risk in the Cost of Insurance Section above), thereby also reducing COIs and/or FAEs (i.e., fixed dollar expenses), and their influence on overall pricing. As such policies with low premium loads and low cash-value-based “wrap fees” (i.e., low percentage rate expenses) perform optimally in maximum accumulation funding strategies and defined-contribution plan designs where higher percentage rate expense levels would otherwise consume a disproportionately greater share of the larger premiums and greater cash value accumulations.

**Mixed Funding Strategy** – Veralytic Reports consider products in which the composition of policy costs is not disclosed (e.g., whole life products) and/or where cost of insurance charges (COIs), fixed administration expenses (FAEs), premium loads, and cash-value-based “wrap fees” (M&Es) are balanced between fixed dollar expenses and percentage rate expenses to offer a mixed funding strategy. Products offering a mixed funding strategy are most suitable in planning situations where the policy is to serve multiple planning objectives (e.g., a policy holding intended to both provide a death benefit for family protection/income replacement which is also used as a supplemental wealth accumulation vehicle).

Insurers also price different products for different markets. Veralytic Reports identify the target market for which the product is priced as either “Retail”, “Institutional” or “Experience-Rated” as determined by the level and construction of policy expenses, and risk characteristics associated with the pool of policyholders for which the policy is designed, as follows:

Target Market

**Retail:** Retail products are generally available to the broadest segment of the market, and are characterized as products with low or no minimum face amount, low or no minimum premium requirement, and higher policy expenses and/or higher up front policy loads and/or higher back-end cancellation fees/surrender charges.

**Institutional:** Institutionally priced products are not generally available to the market as a whole, and are characterized as products that often impose a minimum face amount, a minimum premium requirement, and/or minimum case size (for multi-life cases). Because larger transactions and larger groups of policies cost less to sell, service and administer, insurers typically reduce and/or amortize policy expenses over time for these large transactions to reflect volume discounts and economies of scale. As such, institutionally priced products typically have low or no back-end cancellation fees/surrender charges, and/or no or low up-front policy loads, and/or a generally lower expense structure that is the natural result of greater economies of scale.

**Experience-Rated:** In contrast to the “pooled” pricing of most life insurance policies, experience-rated policies are characterized by the nature of the underlying cost of insurance (COI) charges and/or expenses corresponding to the claims and/or operating experience of a segregated pool of insureds. Insurers pool policies to make risks more predictable. In fact, the larger the pool, the more predictable the risk. Pooling combines large and small policies and low and high risk segments of the pool, and in so doing averages the variables that contribute to premium prices. In effect, this averaging cross-subsidizes smaller transactions and higher-risk segments with excess “profits” from the larger transactions and lower-risk segments in the pool.

	Max. Accum	Mixed	Min. Prem
Retail			
Institutional			
Experience-Rated			

Because different pools have different claims experience, premiums vary depending on the claims experience for the pool being insured. Historically, pools of individual policies with smaller face amounts have the highest claims experience. On the other hand, selective pools of individuals who enjoy healthier lifestyles and better health care live longer, and products priced for this market segment can offer lower COI charges and lower premiums. Of course, products priced for a segregated risk pool that does not actually realize the promised benefits of superior claims experience and/or operating efficiencies from a given market segment will ultimately have to charge higher COI charges and/or higher expenses, resulting in higher premiums.

Experience-rated products are customarily either available on a private placement basis for qualifying transactions, and/or products with high minimum face amounts and/or products only available through proprietary distribution channels that cater to a specific and clearly defined market segment (e.g., high net worth individuals, corporate executives, etc.). In addition, products underwritten by smaller insurers whose distribution systems cater predominantly to market segments with favorable claims and/or operating experience may participate in the pricing advantages of experience-rated products. Lastly, products designed for a particular market segment with favorable claims and/or operating experience (e.g., Joint and Last Survivor policies) may also include pricing advantages of experience-rated products.

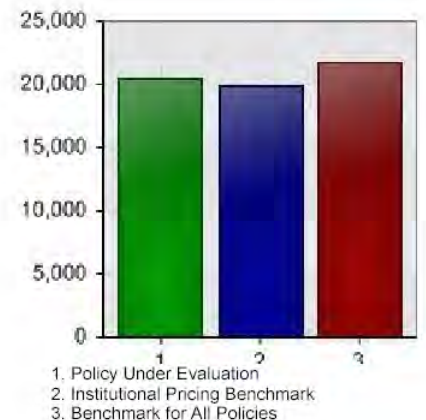
Veralytic Reports, therefore, consider both policy costs as to cost of insurance charges (COIs), fixed administration expenses (FAEs), premium loads and cash-value-based “wrap fees” (e.g., M&Es) as compared to benchmarks, as well as the construction of those costs to determine the policy’s optimal funding strategy as shown in the Pricing Style Box, and assign a ★(full star) for policies whose cost competitiveness is better than average (measured as those products ranking in the top 1/3rd of all products), a ☆(half star) for policies whose cost competitiveness is roughly the same as the average (measured as those products ranking in the middle 1/3rd of all products), and an ☆(empty star) for policies whose pricing is less competitive than average (measured as those products ranking in the bottom 1/3rd of all products) and/or whose pricing makeup is inappropriate to the given situation.

Pricing Stability

Pricing stability also influences the suitability of a permanent life insurance product. While the premium is often considered the price/cost of a life insurance policy, the premium is not the price/cost of the life insurance policy in the same way that a contribution to an Individual Retirement Account (IRA) is not the price/cost of the IRA. In both cases, the price/cost is the sum of the expenses deducted from the premium/contribution. As such, the stability of the planned premium payments in a minimum premium defined-death-benefit policy designs, and/or the reliability of projected benefits in a maximum accumulation defined-contribution policy is always a function of the following formula: **Premiums/Benefits = COIs + E – i%**. To be considered suitable, policy pricing must be adequate to meet the insurer’s future claims obligations based on historical mortality experience, as well as the insurer’s and the servicing organization’s future expenses for service and administration based on historical operating experience, and be based on expected policy interest/earnings that is consistent with historical performance of invested assets underlying policy cash values. The Veralytic Reports assign a ★(full star) for policies whose pricing is based on historical mortality, operating and investment experience, a ☆(half star) for policies whose pricing is either inconsistent with historical experience or where the insurer may lack capacity to control future policy pricing, and an ☆(empty star) where policy pricing is based on mortality improvements, and/or operating gains, and/or investment performance that is unrealistic when compared to the historical performance of the asset classes corresponding to invested assets underlying policy cash values.

In the Premium Comparison graph at the top right of page 2-1 of the Veralytic Report for each product, the Veralytic Report compares the planned premium for the policy under evaluation (PUE) to benchmark premiums based on benchmark cost of insurance charges (COIs), benchmark fixed administration expenses (FAEs), benchmark premium loads, benchmark cash-value-based “wrap fees” (e.g., M&Es) and the same policy interest/earnings assumption as that assumed in the PUE, as shown in the Premium Comparison graph shown to the right (see more on benchmarks at the top of page 4-2 in this section). In addition, Veralytic Reports assess the pricing stability reflected in the illustration of hypothetical policy values by investigating whether expected cost of insurance charges are consistent with actual mortality experience, whether expected policy expenses are consistent with on actual operating experience, and whether expected policy interest/earnings is consistent with the historical performance for the asset classes corresponding to invested assets underlying policy cash values, as follows:

Premium Comparison - Face Amt: \$1,000,000



**Are illustrated/expected COIs adequate to fund the insurer’s future claims?**

In other words, are the illustrated COIs sufficient to cover future claims based on reasonable mortality assumptions? To help answer this question, the Veralytic Research Platform investigates if underlying mortality assumptions differ from recent historic experience, if improvements in mortality or earnings rates are necessary to achieve the illustrated results, and if the mortality rates or illustrated COI charges include some expense charge. The answers to these questions help establish reasonableness and stability of the product’s illustrated COI charges.

In addition, the degree to which an insurer can insure a particular risk on their own paper can influence an insurer’s ability to meet future cost projections. Insurer’s that reinsure a substantial portion of a given risk may be confronted with the need to increase COIs at some point in the future in the event of the dissolution of the reinsurance treaty between the primary insurer and the reinsurer that governs the terms of conditions of the reinsurance arrangement, including the reinsurance rates, and/or the failure of the reinsurer. While a product underwritten by an insurer with lower retention is not in and of itself an unsuitable product, products available from insurers with higher retention are considered to have the greatest control over future pricing/costs, and as such, will be considered more suitable than otherwise, all other things being equal.

**Are illustrated/expected policy expenses adequate to meet future administrative and service requirements?**

Veralytic Reports also consider whether the policy pricing structure is appropriate for the level of service required by the policy type and policy buyer’s needs. All policies require routine administration and service, and these basic costs are usually insurer expenses. The Veralytic Research Platform investigates whether illustrated expenses are consistent with historical experience and how changes in experience might impact future policy performance. In addition to basic services, wealth accumulation and estate planning products typically require advanced design, due care, and policy implementation services usually provided by the servicing organization. These advanced services include Insurance Banking® services to manage underwriting markets; enrollment processing and management; financial modeling; preparation of annual reports to satisfy tax reporting requirements; plan and policy reconciliation; annual policy benefit statements; policy-related trust accounting; annual reviews of insurer and product performance; audits of funding adequacy; compliance and phantom income testing; and ongoing consulting services to monitor policy assets, tax law changes, and regulatory considerations. The costs for these services are often met by sales and service loads allocated to servicing organizations.

While there is no guarantee of good service just because a policy may include sales/service loads, the absence of sales/service loads virtually guarantees that there are little or no value-added administration services included. Veralytic Reports make no attempt to ascertain an appropriate level of service for a given situation as service requirements will vary from client to client. For instance, a product with lower sales/service loads than that for the respective benchmarks may be perfectly suitable for retail products and/or policies purchased for simple, traditional death-protection-only needs. In addition, policies purchased by financially-sophisticated, self-sufficient investors may also be comfortable dealing directly with the insurer on required service issues. On the other hand, larger policies purchased to finance the more advanced insurance needs like business insurance needs, business continuity financing, non-qualified deferred

This Veralytic Report is not valid without all constituent pages, including the cover page and section pages bearing important notes clarifying its proper use.

compensation funding, supplemental benefits funding, and/or wealth transfer financing will likely require more service and administration than the insurance company is prepared to provide. For policies in which sales/services loads prove to be inadequate over time, there could be additional costs and/or fees necessary to meet the service, administration and/or reporting requirements not shown in the initial illustration of hypothetical policy values.

For minimum premium, defined death benefit plan designs, the figure “Premium Comparison” (sample shown on the previous page) in the upper right corner of page 2-1 of the Veralytic Report for an individual product compares premium cost competitiveness (for maximum accumulation, defined contribution plan designs, this chart illustrates the benefit comparison for policy distributions). This “Premium Comparison” illustrates the minimum level annual premium required to endow the policy, assuming the illustrated policy earnings rate and expenses and the policy buyer’s illustrated age and health profile. (See “Assumptions” on page 2-2 of the Veralytic Report for the individual product and/or the bottom of a summary report for all products for a statement of assumptions underlying product specifications, pricing information, and analysis.) This “minimum premium” is generally based on non-guaranteed pricing assumptions, and as such, it is possible that the policy owner may need to pay more than the originally illustrated minimum premium in response to negative policy performance and/or increased policy costs and to prevent the policy from lapsing. Premiums for the policy under consideration are compared with two benchmarks actuarially determined to be representative of the premium for an average but competitively-priced product for each respective market segment (see more on benchmarks at the top of page 4-2 in this section).

### **Are illustrated/expected policy earnings consistent with historical performance?**

Premiums paid in excess of deductions for cost of insurance charges and policy expenses are credited with some form of policy interest or earnings based on product type and the allocation of invested assets underlying policy cash values. For instance, “fixed products” (i.e., universal life and whole life) are required by regulation to invest assets underlying policy cash values predominantly in high-grade corporate bonds and government backed mortgages. As such, the policy interest crediting rate for universal life products and the dividend interest crediting rate for whole life products will generally correlate with the 6.0% historical rate of return on high-grade corporate bonds and government backed mortgages over time (higher for insurers with superior investment performance and/or whose general account portfolio may be comprised of fixed income securities with longer-term maturities, and lower for insurers with inferior investment performance and/or whose general account portfolio may be comprised of shorter-term fixed income maturities).

Likewise, “variable products” (i.e., variable universal life and variable life) generally invest policy cash values in a wide variety of mutual-fund-like separate accounts, and thus the policy earnings rate for variable products will generally correlate with rate of return for the assets classes into which cash values are allocated. For instance, where cash values are allocated to a conservative portfolio comprised of predominantly fixed income securities, the policy earnings rate can be expected to generally correlate with the 6.0% historical rate of return on fixed income securities. Similarly, where cash values are allocated to a moderate portfolio comprised of a balance of fixed income and equity investments, the policy earnings rate can be expected to generally correlate with an 8.0% historical rate of return from balanced portfolios. And to the extent cash values are allocated to an aggressive portfolio comprised of predominantly equity securities, the policy earnings rate can be expected to generally correlate with the 10.0%+ historical rate of return on equity investments (higher for separate accounts with superior investment performance and lower for separate accounts with inferior investment performance).

While life insurance policy pricing and performance projection systems often allow for a wide range of interest and investment earnings assumptions in calculating hypothetical policy values, actual policy performance will ultimately be a function of the actual performance of invested assets underlying policy cash values as described above. In other words, while a particular illustration of hypothetical policy values may reflect a current interest rate declared by the insurer, or an assumed earnings rate chosen by the agent/broker, actual policy earnings will ultimately be the result of actual performance of the invested assets underlying policy cash values (unless artificially subsidized by the insurer). For instance, in periods of low interest rates, it is common for insurers to declare policy interest crediting rates on fixed products that are commensurate with low prevailing interest rates (in much the same way as how banks declare an interest rate on Certificates of Deposit that are generally consistent with prevailing interest rates). Similarly, in periods of high interest rates, insurers have declared policy interest crediting rates that are commensurate with high prevailing interest rates, without regard to the historical rate of return for the invested assets underlying policy cash values.

In addition, some insurers declare higher interest crediting rates for new policy issues than that which is credited to renewing policy issues (e.g., 5.5% interest for new policy issues while inforce policy issues are credited with 5.0%), while others declare a market interest rate at issue with a “bonus interest crediting rate” after some period of time (e.g., 5.0% interest at issue with a 0.5% bonus beginning in the 11<sup>th</sup> policy year). Either way, because these declared rates are generally guaranteed for 1-year or less (considerably less than the expected holding period for permanent policies), and because insurers routinely change declared interest rates both to follow movements in prevailing interest rates and to correlate declared rates with the interest earnings in their portfolio of invested assets underlying policy cash values, The Veralytic Research Platform looks beneath the current policy crediting rate in determining pricing stability to instead consider both historical rates of return for the asset classes underlying policy cash values and the historical investment performance the insurers general account portfolio (see Historical Performance section for more discussion).

Variable products allow for an even wider range of interest and investment earnings assumptions in calculating policy pricing and projected performance where policy earnings expectations are not generally set by the insurer, are instead chosen by the agent/broker, and generally not necessarily correlated with the actual rates of return for invested assets underlying policy cash value allocations. For instance, current policy pricing and performance projections systems generally allow for the use of any policy earnings assumption between 0.0% and 12.0% without regard to the actual asset allocation of the mutual-fund-like separate accounts underlying policy cash values. In other words, even though a given client risk profile may dictate a moderate asset allocation where invested assets underlying policy cash values would be balanced between fixed income and equity-type separate accounts, and where such a moderate asset

allocation would be expected to produce an 8.0% expected rate of return, current policy pricing and projection systems allow for projected earnings rates as high as 12.0%.

Because the Veralytic Research Platform does not know the policyowner's risk profile, Veralytic Reports do not consider the illustrated/expected rate of return for variable products in its pricing stability assessment as it would otherwise relate to the asset allocation appropriate to the policyowner's risk profile. However, Veralytic Reports do comment on the asset allocation which would generally correspond to the illustrated/expected rate of return so the practitioner can either change/confirm actual policy asset allocations are consistent with the illustrated/expected rate of return, or change the illustrated/expected rate of return to be consistent with the actual asset allocation. The Veralytic Research Platform does also look beneath the assumed policy earnings rate to again consider the historical performance of the actual mutual-fund-like separate accounts within the policy (see Historical Performance section for more discussion).

All together, Veralytic Reports consider policy pricing to be stable when pricing appears adequate to meet both the insurer's future claims obligations based on historical mortality experience, as well as the insurer's and the servicing organization's future expenses for service and administration based on historical operating experience, and when expected policy interest/earnings is consistent with historical performance of invested assets underlying policy cash values. The Veralytic Reports assign a ★(full star) for policies whose pricing is based on historical mortality, operating and investment experience, a ☆(half star) for policies whose pricing is either inconsistent with historical experience or where the insurer may lack capacity to control future policy pricing, and an ☆(empty star) where policy pricing is based on mortality improvements, and/or operating gains, and/or investment performance that is unrealistic when compared to the historical performance of the asset classes corresponding to invested assets underlying policy cash values.

While the Veralytic Research platform has no way of predicting whether a policy will perform as illustrated, Veralytic Reports can consider whether the values illustrated are consistent with the insurer's historical experience, whether the basis of that experience has been fully disclosed, and how potential changes in experience might impact future policy performance. However, a favorable suitability rating for pricing stability does not guarantee future policy performance. In the event that illustrated/expected COI charges are insufficient to fund future death claims, or if illustrated/expected policy expenses are not adequate to cover anticipated expenses and services, or should the actual policy interest/earnings rate be less than the illustrated/expected policy interest/earnings rate, then higher premiums than originally calculated may be required to maintain policy benefits, or benefits may need to be reduced in order to be maintained, or the policy can lapse without value and without paying a death benefit.

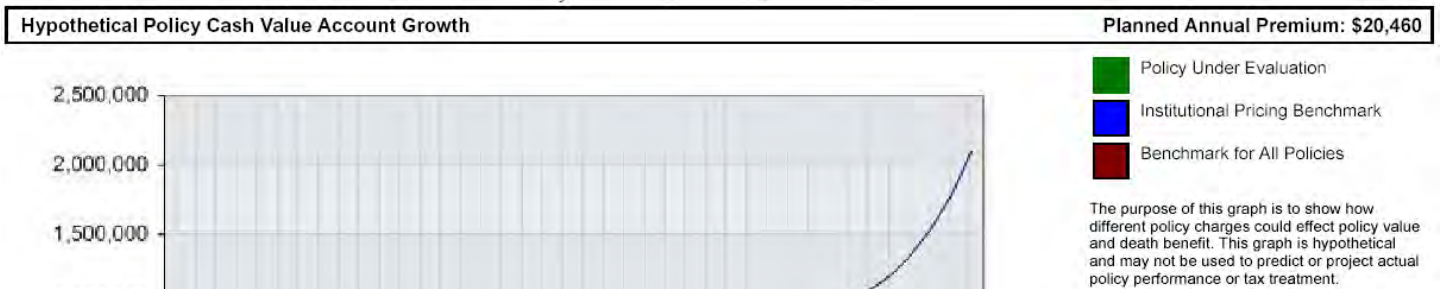


## Relative Policy Value

The suitability of a permanent life insurance product is also influenced by the degree of cash value liquidity throughout the life of the policy. All other factors being equal, the higher the liquid cash value after deduction of cost of insurance charges and policy expenses (including contingent surrender charges), the more suitable the policy. As such, the Veralytic Research Platform measures cash value liquidity for the product under evaluation (PUE) in relation to the Veralytic Benchmarks (see more on benchmarks at the top of page 4-2 in this section) based on the following formula: **Premiums - COIs - E + i% = Cash Value**, and then measures relative policy value over the short term (as measured by the illustrated cash surrender value at the end of the 1st policy year), the midterm value (as measured by the illustrated cash surrender value at the end of the 10th policy year), and the long term value (as measured by the illustrated cash surrender value at the end of the 20th policy year). Veralytic Reports also place more weight on higher liquidity and policy value over the short term, and to a lesser degree over the midterm and long term measurement periods. Veralytic Reports then assign a ★(full star) to policies whose relative liquidity and policy value is higher than average in all three (3) short, mid, and long-term measurement periods, a ★(half star) to policies whose relative liquidity and policy value is higher than average in any two (2) of the three measurement periods, and an ☆(empty star) to policies whose relative liquidity and policy value is higher than average in only one (1) or none (0) of the three measurement periods.

Cash value, or cash surrender value (CSV), is a defining characteristic of permanent life insurance. In simple terms, CSV is the value available to the policyholder if the policy is surrendered (i.e., cash value minus surrender charges). But since CSVs do not account for paid-in premiums, they offer no basis for direct comparisons of policy values. On the other hand, liquidity ratios can be used to compare relative policy values and account for paid premiums. A policy's liquidity ratio equals CSV at the end of a given policy year divided by the cumulative premiums paid through the end of that policy year. The Veralytic Reports measure short-term (i.e., 1st year), mid-term (i.e., years 1 through 10), and long-term (i.e., over the life of the policy) liquidity ratios for the policy under consideration and compares ratios with established benchmarks.

The figure "Hypothetical Policy Cash Value Account Growth" located near the bottom of page 2-1 of the Veralytic Report for each product summarizes comparison data for cash value accumulations, duration of coverage, liquidity ratios (i.e., value/premium ratios), and surrender charges for the policy under consideration.



This figure illustrates the effects of various policy charges and the timing of those charges on policy value and death benefits. Assuming the illustrated premium, policy cash values for the policy under consideration are compared with actuarially determined representative cash values for policies priced for institutional markets and with actuarially determined representative cash values for a competitive product of the same product type.

In general, higher CSVs and higher liquidity ratios give policy holders more planning options, greater flexibility, and better exit strategies in the event of changes in facts and circumstances or changes in tax law or other regulations. If all other suitability factors are equal, the Veralytic Reports consider higher CSVs, higher liquidity ratios, and lower or leveled surrender charges more suitable.

Policy/Benchmark	Est Yr 1 Cash Value / Premium Ratio	Surrender Charge	Yrs Applied	Average Decrease %/Yr	Death Benefit @ Endowment/Maturity	Gross % Return	Net % Return	Net Net % Return
Policy Under Evaluation	0.00%	100.00%	9	11.11%	\$1,000,880	8.87	8.00	7.95
Benchmark for Institutionally-Priced Policies	80.00%	0.00%	N/A	N/A	\$1,000,880	8.86	8.00	7.45
Benchmark for All Policies	0.00%	88.00%	11	8.00%	Lapse @ Y33	8.86	8.00	7.40



While a policy does not necessarily need to endow, the Veralytic Research platform generally measures policies under the presumption that the policy will endow. Funding the policy to endow offers policyholders benefits. First, if a policy does not endow, the policyholder can potentially lose the entire investment in the insurance contract as well as the death benefit. Also, if the policy is funded to endow, some insurers will extend maturity beyond the original endowment/maturity age. In that case, if the policyholder survives beyond the original maturity date, the CSV is paid at maturity but is taxable to the extent the CSV exceeds the premium “investment.” Similarly, no deduction is allowed for any loss (i.e., CSV minus premiums) realized on the policy. However, because policy cash values are “confiscated” upon the death of the insured, any benefits of endowing the policy cash value in an amount to equal to the face amount must be weighted against the added premium required to endow.

Finally, persistency (i.e., the percentage of policies that remain in force from one year to the next) can also influence relative policy value. When a policy terminates with no value or is voluntarily surrendered, it is considered to have lapsed. Since premature surrender may indicate the policyholder’s dissatisfaction with service, low lapse rates, (i.e., the rate at which a particular insurers’ policies have lapsed), may suggest greater customer satisfaction. Also, all other factors being equal, insurers with low lapse rates can often price policies more competitively because they have more margin available from the greater renewal premiums. In any case, low lapse rates and high persistency may tend to suggest greater relative value.

All things considered, the Veralytic Research Platform places more weight on higher liquidity and policy value over the short term, and to a lesser degree over the midterm and long term measurement periods, and assigns a ★(full star) to policies whose relative liquidity and policy value is higher than average in all three (3) short, mid, and long-term measurement periods, a ★(half star) to policies whose relative liquidity and policy value is higher than average in any two (2) of the three measurement periods, and an ☆(empty star) to policies whose relative liquidity and policy value is higher than average in only one (1) or none (0) of the three measurement periods.

**Historical Performance**

The suitability of any permanent life insurance policy is generally influenced by the number of cash value investment options, the historical performance of such cash value investment options, and cost-effectiveness of the various cash value allocation options. Cash values of traditional products are invested in the insurer’s general account managed by the insurer and required by regulation to invest predominantly in fixed income securities like high-grade corporate bonds and government backed mortgages. Cash values in variable products are directed by the policyowner among a family of mutual-fund-like separate accounts offering a wide range of asset classes typically including an assortment of domestic and foreign stock funds, an array of domestic and foreign bond funds, a money market account, and usually a fixed account (typically the same as the insurer’s general account). In either case, the Veralytic Reports assign a ★(full star) to policies whose performance of invested assets underlying policy cash values are superior to peer group products, a ★ (half star) to policies whose performance of invested assets underlying cash values are roughly the same as peer group products, and an ☆(empty star) to policies whose performance of invested assets underlying policy cash values is inferior to peer group products.

In both cases, Veralytic Reports include the historical performance of invested assets underlying policy cash values in the “Product Profile” located at the top left of the page 2-1 of the Veralytic Report for each product, examples of which are shown below:

<u>Traditional Products</u> (Universal Life & Whole Life General Account)			<u>Variable Products</u> (Self-Directed Separate Accounts)		
<u>Policy Under Evaluation</u>		<u>Avg for All Policies</u>	<u>Policy Under Evaluation</u>		<u>Avg for All Policies</u>
6.89%	5-yr Avg. Net Portfolio Yield*	6.53%	38	# of Funds	37
			28	# of Top Performers	24
			0.87%	Avg Inv Mgmt Fee	0.86%

To evaluate the suitability of the cash value investment options for the policy under evaluation (PUE), the Veralytic Research Platform reviews the performance of invested assets underlying policy cash values, the number and diversity of cash value investment options, and the expense ratios for invested assets underlying policy cash values, as follows:

**Superior Historical Performance is More Suitable** – Better historical performance also contributes to suitability. While past performance does not guarantee future performance, the historical performance of invested assets underlying policy cash values is the best available gauge of performance suitability. As such, Veralytic Reports measure the historical performance of invested assets underlying universal life and whole life cash values by comparing the 5-year average net portfolio yield on the insurer’s general account, as reported by VitalSigns (a service offered by EbixExchange that collects and compiles general account net portfolio yield data for all insurers and which must be separately licensed for use in Veralytic Reports) against the average 5-year net portfolio yield on the general accounts for all other insurers. Similarly, Veralytic Reports measure the historical performance of invested assets underlying variable life cash values by comparing the star ratings published in Morningstar (a service offered by Morningstar Inc. that collects and compiles Separate Account performance data and which must be separately licensed for use in Veralytic Reports) to the star ratings of separate accounts found in all other variable life products. Although VitalSigns and Morningstar data and ratings are objective in the sense that they are not influenced by economic forecasts or subjective opinions about fund management strategies, these rating methods like all ratings methods produces certain biases. For instance, because the Veralytic Research Platform cannot consider the policyowner’s risk profile and corresponding asset allocation, products with superior historical performance are rewarded equally, without regard to volatility. As such, Veralytic Reports tend to favor traditional products which report high 5-year net portfolio yields without regard to the volatility of that performance, and tends to favor variable products which report a high number of separate account funds rated 3-stars or higher by Morningstar.

**Greater Diversity Improves Suitability** – It is generally accepted under the principles of Modern Portfolio Theory that diversification improves the overall return expected from a given portfolio and reduces volatility expected within a given portfolio. As such, since cash values of a variable life policy are invested in a given family of funds, the greater the diversity among separate accounts, the more favorable the cash value allocation options. In other words, the greater the number of separate accounts and the greater the number of different types of funds, the more opportunity for diversification and broad asset allocation and the more suitable the cash value allocation options. For the variable life products, Veralytic Reports compare the total number of underlying separate accounts with the average number of underlying separate accounts for all policies of the same product type. In general, the greater the number of underlying separate accounts, and the broader the coverage of the different types of styles of funds, the more suitable the cash value allocation options. However, because traditional universal life and whole life products must be invested by regulation predominantly in fixed income securities like high-grade corporate bonds and government backed mortgages, and because such fixed income investments are managed by the insurer and generally not disclosed, Veralytic Reports do not penalize traditional products for lack of diversity.

**Lower Expense Ratios are More Suitable** – Since investment expenses are paid before returns are passed through to cash values, the Veralytic Report also considers expense ratios in determining the suitability of underlying cash value allocation options. Typically, investment expenses include investment management fees, investment advisory fees, and fund operating expenses, which are together commonly referred to as fund management fees or FMEs. To assess relative cost-effectiveness of cash value investment options, Veralytic Reports compare these investment expense ratios (i.e., the ratio of investment expenses to investment values) for the policy under consideration with the average expense ratio for all policies of the same product type. In general, lower expense-to-value ratios are considered more suitable. However, because traditional universal life and whole life products generally do not disclose such investment expenses, Veralytic Reports cannot consider investment expenses incurred within the general account of traditional products. Also, because neither cash-value-based investment expenses, cash-value-based insurance expenses (e.g., M&Es discussed in the Cost Competitiveness section above), nor life insurance policy earnings are generally reported in a standardized manner, Veralytic Reports measure cash value performance and cash-value-based expenses, as follows:

- **Gross Rate** – The *gross* policy interest/earnings rate is that rate of return credited to policy cash values reported *before* deduction of *investment*-related fund management expenses (FMEs) and *before* deduction of cash-value-based *insurance* expenses. The gross rate is typically disclosed in variable life products but not typically disclosed in traditional universal life and whole life products, and either way is directly related to the rate of return on invested assets underlying policy cash values (e.g., 6.0% for a conservative allocation of predominantly fixed income investments, 8.0% for a moderate allocation of a balance of fixed income and equity investments, and 10.0%+ for an aggressive allocation predominantly equity investments), and thus is more of a general “**asset class rate of return**” than a policy specific rate of return. The reporting of the gross policy earnings rate is also somewhat unique to life insurance products as rates of returns for investment products are most often reported net of FMEs. As such, while the Gross Rate may be an interesting piece of information at is relates to benchmark performance of the respective asset classes underlying policy cash values, because it does not reflect the earnings actually credited to policy cash values, it is most useful as a starting point in setting reasonable expectations as to the investment performance of policy cash values.
- **Net Rate** – The *net* policy interest/earnings rate is that rate of return credited to policy cash values reported *after* deduction of *investment*-related FMEs, but before deduction of cash-value-based *insurance* expenses. In other words, this “Net Rate” is equal to the Gross Rate minus FMEs, and as such is most closely analogous to the “**investment rate of return**” on policy cash values (e.g., universal life policy interest crediting rates and whole life dividend interest crediting rates are generally reported *after* corresponding investment expenses in the same way as bank certificates of deposit report interest *after* deduction of related investment expenses and variable life separate account earnings rates are reported *after* corresponding investment expenses in the same manner as how mutual funds report earnings *after* deduction of related investment expenses). As such, because the Net Rate is derived directly from the Gross Rate for the given asset allocation, and because FMEs are a function of that asset allocation (i.e., FMEs are lower for conservative fixed income cash value allocations than for aggressive equity allocations that may include higher cost international and/or emerging market asset classes), the Net Rate is most useful in comparing hypothetical policy performance between different products, and is thus used to compare the performance of the policy under evaluation to the hypothetical performance of the Veralytic benchmarks. For reasons explained further immediately below, this Net Rate can also be referred to as the “Single Net Rate”.
- **Net-Net Rate** – The *net-net* policy interest/earnings rate is that rate of return credited to policy cash values reported *after* deduction of *both investment* FMEs and cash-value-based *insurance* “wrap fees” (e.g., M&Es). In other words, this “Net-Net Rate” is equal to the Net Rate minus M&Es, and because this Net-Net Rate reflects the rate of return reported on policy cash values after *all* cash-value-based fees, it can also be referred to as the “**policy rate of return**” or the “Double Net Rate” (i.e., the rate of return on policy cash values after deduction of both investment *and* insurance “wrap fees”, but not considering COIs, FAEs nor premium loads). Because this Net-Net Rate is a function of the individual policy holding, and is not a function of the policy asset allocation, nor the expected Gross Rate corresponding to that asset allocation, nor the corresponding investment expenses for that asset allocation, the Net-Net Rate is most useful in measuring the appropriateness of policy expenses (e.g., because the Net-Net Rate is the rate of return at which cash values would otherwise grow but for the deduction of all other policy expenses, the Net-Net Rate is also useful in accounting for differences in the timing and amount of COIs, FAEs and premium loads between one policy holding and another).

Because certain policy holdings may or may not disclose all of the "Gross Rate", the "Net Rate", and the "Net-Net Rate", and because certain policy holdings may not clearly distinguish between the "Gross Rate", the "Net Rate" and the "Net-Net Rate", the Veralytic Research Platform performs all performance and expense computations based on a consistent Net Rate, as shown below:

Policy/Benchmark	Est Yr 1 Cash Value / Premium Ratio	Surrender Charge	Yrs Applied	Average Decrease %/Yr	Death Benefit @ Endowment/Maturity	Gross % Return	Net % Return	Net Net % Return
Policy Under Evaluation	0.00%	100.00%	9	11.11%	\$1,000,880	8.87	8.00	7.95
Benchmark for Institutionally-Priced Policies	80.00%	0.00%	N/A	N/A	\$1,000,880	8.86	8.00	7.45
Benchmark for All Policies	0.00%	88.00%	11	8.00%	Lapse @ Y33	8.86	8.00	7.40

While certain practitioners may disagree with the use of a consistent Net Rate for comparison of hypothetical performance and corresponding expenses, and instead suggest that using a consistent Gross Rate produces a more accurate means of policy comparison, the use of a consistent Gross Rate for the purposes of such comparisons is only valid when the appropriate cash value allocation is known and also made consistent in all products under evaluation. For instance, consider a comparison of performance and costs between two products based on a consistent 8.0% Gross Rate but where the cash value allocation is assumed to be balanced among both fixed income and equity asset classes with an average FME of 100 bps in Product A, while Product B is assumed to allocate 100% off cash values to a stable value account with low FMEs of only 25 bps, as shown below:

This Veralytic Report is not valid without all constituent pages, including the cover page and section pages bearing important notes clarifying its proper use.

	Product A	Product B
Gross Rate	8.00%	8.00%
Less Investment Wrap-Fees (FMEs)	1.00%	0.25%
<b>Net Rate</b>	7.00%	7.75%
Less Insurance Wrap-Fees (e.g., M&Es)	0.75%	0.75%
<b>Net-Net Rate</b>	<b>6.25%</b>	<b>7.00%</b>

As shown above, comparing policy holdings based on a consistent Gross Rate, but without knowing and also making consistent the cash value asset allocation, can result in understated investment expenses and overstated policy performance. Because the Veralytic Research Platform has no way of knowing the proper asset allocation for the policy under evaluation, Veralytic cannot ensure consistent comparison of policy performance and costs based on the Gross Rate. In addition, because the asset allocation can and typically does change over the life of a given policy, which in turn also changes investment expenses for that policy, and because Separate Account funds are frequently added to and deleted from a given product, which in turn again changes investment expenses for that policy, comparing policy holdings based on a consistent Gross Rate produces inconsistent results over time (e.g., a product considered by Veralytic Reports to offer low costs based on one illustrated asset allocation could be assigned a different rating based on a different cash value allocation). On the other hand, because cash-value-based insurance expenses (e.g., M&Es) are set at the time of policy issue, and do not change from that pre-set schedule, comparing policy holdings based on a consistent Net Rate will produce consistent results over time.

As such, the Veralytic Research Platform performs all performance and cost evaluations based on a consistent Net Rate, assign a ★ (full star) to policies whose performance of invested assets underlying policy cash values net of investment expenses are superior to peer group products, a ★ (half star) to policies whose performance of invested assets underlying cash values after considering investment expenses are roughly the same as peer group products, and an ☆ (empty star) to policies whose performance of invested assets underlying policy cash values is inferior to and/or where investment expenses are high when compare to peer group products.

# Glossary



Nothing contained in this Veralytic Report is to be considered as a rendering of legal, tax or investment advice for specific cases, and readers are responsible for obtaining such advice from their own legal, tax and investment counsel. Accordingly, no representations or warranties are made by anyone, including, without limitation, Veralytic and anyone engaged in the preparation and distribution of this report, as to the validity or effectiveness of the legal or tax conclusions, analysis, opinions, and planning ideas expressed in this Veralytic Report. Any and all liability whatsoever that may arise in connection with anything contained herein is hereby disclaimed. This Veralytic Report is intended for educational and informational purposes only.

This Veralytic Report is based on carrier illustration and product information available at the time of preparation. It represents Veralytic's best judgment and analysis of the due care process. Due care is a complex field, and many of the areas covered are still evolving. Veralytic does not warrant the completeness of this treatment and recognizes that there is room for a difference of opinion in some areas. Furthermore, there is no definitive guidance on the tax implications of some of the specific product features found in today's life insurance policies. A qualified tax advisor should always be consulted before implementing a program in which the buying decision is based in part on anticipated tax consequences.

**Account value:** The value of the cash value account before deduction of early termination penalties. The account value is calculated by starting with the account value at the beginning of the policy year, adding premiums paid, subtracting monthly deductions for cost of insurance charges (COIs) and policy expenses, and adding investment interest/earnings to result with the end of year account value.

**Benchmarks:** The practice of benchmarking is well-established and quite common in the financial services industry where the performance of a financial instrument is frequently compared to a standard, independent point of reference (e.g., the Dow Jones Industrial Average, the S&P 500, the NASDAQ, and the Wilshire 5000). Since comparable benchmarks are not available for comparing permanent life insurance products, the Veralytic Report uses actuarially determined representative costs and performance levels for competitive products of a specified product type.

**Cash surrender value (CSV) or cash value:** The value available to the policy holder if the policy is surrendered. If no loans are outstanding, this amount is generally available in cash. If loans have been made, the amount available on surrender is equal to the total cash value less the outstanding loan.

**Cash-value-based "wrap fees":** Cash-value-based "wrap-fees" are calculated as a percentage of either the policy account value or the policy cash surrender value. While these percentages are generally disclosed in either the policy prospectus, product guide and/or in the footnotes of the illustration, these percentages can and often do vary from year-to-year.

**Cost of insurance charges (COI):** Charges to cover the insurer's cost of paying death benefits. Current or expected COI charges are based on current or expected mortality experience, often including a margin for expenses or adverse deviations. These COI charges are analogous to current term insurance premiums for the amount at risk. Contracts also specify guaranteed maximum COI charges.

**Death benefit:** The total amount payable to the beneficiary upon the death of the insured. If loans are outstanding at the time of death, the actual cash payment is equal to the death benefit less the amount of the outstanding loan. The death benefit may include amounts in addition to the initial face amount of the policy such as accumulated dividends, the accumulation value of universal life policies, or increases forced by the death benefits corridor.

**Death benefit option:** Universal life and variable life policies generally offer two (2) types of death benefits: 1) Option A or 1 where death benefits are level and equal to the original face amount in all years, and 2) Option B or 2 where death benefits are equal to the original face amount plus the account value of the policy, and thus are generally increasing (but also can be decreasing if/when policy account values are declining but usually not less than the original face amount). Whole Life policy death benefits are similarly either level (when mixed with a term insurance) or increasing during premium payment years (and then decreasing after premium payments have stopped, but again usually not less than the original face amount).

**Endowment:** The point at which a policy's cash value equals its face amount. For policies satisfying the definition of life insurance under IRC §7702, endowment/maturity can occur no sooner than age 95. [Also see maturity.]

**Expense charges:** Charges made on accumulation-type policies to reimburse the insurer for a portion of its costs of issuing and maintaining the policy. Some expense charges are deducted from the gross premiums paid. Others are monthly charges deducted from the accumulation value.

**Experience-rated pricing:** A pricing method that bases prices for insurance products on the actual expenses and claims experience for the pool being insured. Because selective pools that enjoy healthier lifestyles and better health care tend to live longer, products priced for these pools have lower COI costs and lower premiums.

**Face amount:** The death benefit provided by a life insurance policy. This term most often applies to the amount of insurance specified on the "face" of the policy at the time of issue. In this case, "face amount" does not include post-issue changes in total death benefits such as those arising from paid-up additions or death benefit increases caused by growth in account values. However, some illustrations use "face amount" to apply to the total policy death benefit at any given time.

**Fixed administration expenses:** Fixed administration expenses are generally calculated as either a fixed rate per period (e.g., \$100 per month) or a fixed rate per \$1,000 of policy face amount (e.g., \$1.00 per \$1,000 of policy face amount), or some combination of the two. While these rates are generally disclosed in either the policy prospectus, product guide and/or in the footnotes of the illustration, these rates can vary with either the policy face amount and/or the amount of total death benefit if different.

**Fixed premium:** Payments of a fixed, equal amount paid to an insurance company for insurance or an annuity.

**Flexible premium:** For universal life policies, non-fixed payments designed to adapt premiums to the policy holder's changing needs and financial conditions. [See universal life.]

**General account:** All the assets of a life insurance company other than those held in separate accounts. Separate accounts, or sub-accounts, are typically used for variable products, which pass actual investment experience including all capital gains and losses through to policy cash values. The assets backing all other products are held in the general account. The general account may be “segmented” to allocate certain investments to certain blocks of business for the purpose of setting current crediting rates. However, whether or not the general account is segmented, all general account assets are available when any line of business needs additional cash to pay current benefits. Thus, the safety of any general account product depends on the financial strength of all the company’s product lines.

**Health profile:** The collection of health indicators insurers use to rate a policy buyer’s mortality risks. [Also see preferred, preferred plus, standard, substandard, and uninsurable.]

**Institutional pricing:** The pricing style that reflects the volume discounts and economies of scale available from large transactions and large groups of policies. Qualifying transactions typically require face amounts in excess of \$1 million, policies with reduced or leveled load/expense structures, or policies with low or no surrender charges or cancellations fees.

**Insurance Banking®:** The practice of assembling and managing portfolios of insurance, typically with policies of larger than average face amounts, often in excess of a single insurer’s retention limits. The ability to provide high quality Insurance Banking® services depends upon negotiating and placing large blocks of insurance and requires lead underwriting experience and established relationships with many insurers.

**Investment management fee:** A charge made as a percentage of a variable policy separate account fund value to pay the investment advisor for the selection and management of investments. These fees are set in advance and typically vary by fund. Although no comparable explicit charge is made with fixed-interest products, insurers deduct the expenses of investment management for these general account products before setting their declared interest or dividend rates.

**Lapse rate:** The percentage of policies that terminate with no value or are voluntarily surrendered each year. Because insurers typically lose money on a statutory basis in the first year a policy is in force (i.e., their mortality, reserve, expense, sales compensation, and underwriting costs are greater than the premiums they receive), they rely on renewal premiums to repay these initial costs. In most cases, if lapse rates are greater than expected, the insurer will either not recoup or delay the recoupment of its initial excess expenses. An insurer with a low lapse rate, everything else being equal, can price its policies more competitively because it will have more margins available from the greater renewal premiums.

**Life expectancy:** The actuarially projected period of time a person is expected to live. Life expectancies are averages based on factors such as the gender and current age of an individual. Although illustrations may sometimes be provided for durations only up to “life expectancy,” roughly half the population would be expected to live beyond life expectancy.

**Liquidity ratio:** The cash surrender value for a given policy year divided by the cumulative premiums paid through the end of that policy year.

**Maturity:** The point at which a policy’s cash value equals its face amount. For policies satisfying the definition of life insurance under IRC §7702, endowment/maturity can occur no sooner than age 95. [Also see endowment.]

**Maximum accumulation:** An insurance funding strategy where the policy buyer specifies the contribution amount and the insurer determines the value that will be accumulated; often referred to as a defined contribution design.

**Minimum premium:** An insurance funding strategy where the policy buyer specifies the amount of the death benefit desired and the insurer determines the minimum premium needed to fund the policy, referred to as defined benefit design. Depending on whether or not this minimum premium is guaranteed by the insurer, it is possible that the policy owner may need to pay more than the originally illustrated minimum premium in response to negative policy performance and/or increased policy costs and to prevent the policy from lapsing.

**Mortality and expense (M&E) risk charges:** A separate charge made on variable products as a percentage of the account value to cover the insurer’s potential deficiencies in the explicit cost of insurance and expense charges. In the absence of poor experience, the M&E risk charge contributes to insurer profits. No comparable explicit charge is made with general account products; on those products, similar loads are part of the undisclosed spread between credited and earned interest rates.

**Mortality cost:** The cost imposed on the policyholder by the insurance company to cover the amount of pure insurance protection for which the insurance company is at risk. With term insurance, the insurance company is generally exposed to risk of loss for the entire face amount of the policy. With permanent insurance, the net amount at risk for the insurance company is the difference between the policy’s death benefit and the cash value.

**Mortality table:** A table that presents expected death rates by individual age. The death rates vary from one mortality table to another depending upon the type of experience on which the data is based. Large insurance companies will often develop their own mortality tables based on experience under their own policies.

**Never smoked:** A health profile designation for policy buyers who have never used tobacco products. [Also see tobacco use.]

**Nonsmoker:** A health profile designation for policy buyers who have not used tobacco products for at least two years and can be as long as ten years. [Also see tobacco use.]

**Paid to age X:** A policy funding strategy where premiums are paid until the policy holder attains a pre-determined age.

**Paid for X years:** A policy funding strategy where premiums are paid for a pre-determined number of years.

**Paid over the life of the policy:** A policy funding strategy where premiums are paid throughout the life of the policy.

**Permanent life insurance:** Insurance intended to provide life insurance protection for the entire life of the insured. Permanent insurance differs from term insurance in that its premium structure includes a savings component. Permanent insurance policy premiums have two components, the insurance cost (mortality cost, administrative fees, sales loads, etc.) and the savings component. The savings component typically is referred to as cash value. The policyholder may use the cash value to make the minimum premium payments necessary to maintain the death benefit protection, may access the cash value by taking out loans or making partial surrenders, or may use any combination of these techniques. If permanent insurance is surrendered before death, a surrender charge may be assessed against the cash value. Generally, surrender charges are assessed if the policy is surrendered within the first 10 or 20 years. The amount of money a policyholder will receive upon surrendering a policy is referred to as the cash surrender value (CSV).

**Planned annual premium:** Payments to the insurance company to buy a policy and to keep it in force.

**Preferred:** A risk class designation for nonsmokers whose health profiles are likely to result in better than average mortality risks. [Also see risk class and health profile.]

**Preferred plus:** A risk class designation for policy buyers whose superior health profiles are likely to result in lower than average mortality risks. [Also see risk class and health profile.]

**Premium duration:** The period during which premiums are paid.

**Retail pricing:** The pricing style used for large, non-selective pools of individual policy holders that relies on the "Law of Large Numbers" and averages costs for high- and low-risk segments of the pool.

**Risk class:** The level of cost of insurance charges assessed against the policy or the gross premium rate. Based on the information submitted with the application, the policy is categorized into a preferred, standard, or substandard (impaired) risk class. Policies can also be issued in preferred plus classifications. These generally mean that the insured demonstrates superior health characteristics in addition to being a nonsmoker, such as frequent exercise or having a family history of longevity.

**Separate accounts:** Insurance company assets that support only cash values of specific policy forms and are completely separated from the general account investments that back the rest of the company's products. Separate accounts are typically used for variable products, which pass actual investment experience including all capital gains and losses through to policy cash values. [Also see general account.]

**Smoker:** A health profile designation for policy buyers who have used tobacco products within the last two years. [Also see tobacco use.]

**Standard:** A risk class designation for policy buyers whose health profiles are likely to result in average mortality risks. [Also see risk class and health profile.]

**Substandard:** A risk class designation for policy buyers whose impaired health profiles are likely to result in higher than average mortality risks. [Also see risk class and health profile.]

**Surrender charge:** An amount deducted from the accumulation value to yield its cash surrender value. These charges, typically found in the first 10 to 20 policy years, enable the insurer to cover a portion of unrecovered issue costs on policies that surrender early.



**Target premium:** The amount of premium on flexible premium policies on which full commissions are paid. Policies that allow flexible premiums often achieve much of their competitive posture in high-premium scenarios by having lower commission rates apply to the excess premiums paid above the target premium.

**Temporary life insurance:** Various forms of term life insurance that provide life insurance protection for a specified time period. [Also see term life insurance.]

**Term life insurance:** Temporary insurance that provides life insurance protection for a specified time period. Death benefits are payable only if the insured dies during the specified period. If a loss does not occur during the specified term, the policy lapses and provides no further protection. All premiums are retained by the insurance company. Typically, term insurance premiums do not have a savings component; thus, term insurance does not usually create cash value.

**Tobacco use:** A health indicator insurers use to describe a policy buyer's use of tobacco products. [Also see nonsmoker, never smoked, and smoker.]

**Uninsurable:** A risk class designation for policy buyers whose health profiles render them unsuitable for individual life insurance. The policy buyer could be eligible for joint life insurance with a second insurable policy buyer. [Also see risk class and health profile.]

**Universal life:** A form of permanent insurance designed to provide flexibility in premium payments and death benefit protection. The policyholder can pay maximum premiums and maintain a very high cash value. Alternatively, the policyholder can make minimal payments in an amount just large enough to cover mortality and other expense charges.

**Variable life/Variable Universal Life:** A whole life or universal life insurance policy for which cash values are invested in separate account funds that provides a death benefit dependent on market value of the policy's underlying investments at the time of death. The policy owner chooses among various funds offered by the insurer, permitting investments concentrating in common stock and other assets that are more volatile, but may provide higher long-term returns, than an insurer's general account. Actual investment fund performance, both net investment income and capital gains and losses, pass directly through to policy cash values after reduction for investment expenses and fund operating costs.

**Whole life:** A traditional form of permanent insurance that guarantees a continued death benefit for the insured's entire life upon payment of fixed annual premiums, which are usually level for life, based on the insured's age at issue.

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Many of the definitions used in this Glossary were previously published in the second edition of *The Insurance Counselor: Life Insurance Due Care* prepared and researched by Richard A. Schwartz and Catherine R. Turner for M Financial Group and published in 1994 by the American Bar Association.



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## Subject: Barry Flagg: 6 Essential Ingredients to Life Insurance ADVICE

*“Life insurance is an essential planning tool for many financial and estate planning professionals. Its unique tax preferences, risk management characteristics, and asset protection qualities often make it an ideal tool for asset protection and/or income tax planning, estate planning and/or estate tax financing, and funding buy-sell agreements and/or supplemental retirement plans. However, life insurance remains the last, largest, most-neglected asset in the planners’ planning and on clients’ balances sheets. As is often the case, neglect breeds poor-performance, and life insurance is no exception, having been among the worst-performing asset-types relative to clients’ expectations for decades, and now the source of growing complaints, arbitration and litigation against advisors, brokers and insurers. The good news is the life insurance industry is being transformed by the same mega-forces that transformed the investment business over the past four decades, bringing with it the promise of greater transparency, lower costs, and better performance. Understanding these transformative forces will help financial and estate planning professionals better advise clients about the prudent selection/retention and proper management of life insurance holdings.”*

In his commentary, **Barry Flagg** discusses the 3 mega-forces that transformed the investment business, how these same 3 mega-forces are transforming the life insurance business, and how to use new Best Practice Standards to 1) define roles and responsibilities of the life insurance professional in a manner that ensures client’s best interests are served, 2) analyze client’s circumstances, goals and objectives in a way that more naturally leads to prudent product selection or retention, 3) strategize defining characteristics of product types most aligned with client’s interests, 4) formalize the search criteria for best-available rates and terms (BART) that considers inherent constraints and conflicts of interest, 5) implement best-available rates and terms (BART) while avoiding prevailing life

insurance industry practices now considered “misleading”, “fundamentally inappropriate”, and unreliable by financial, insurance, and banking industry authorities, and 6) monitor the factors affecting performance to reduce the risk of client disappointment and ensure client’s interests are served over time.

**Barry Flagg, CFP®, CLU, ChFC, GFS®** is inventor and founder of Veralytic® - a leading publisher of pricing and performance research and ratings for life insurance products. Veralytic is the invention of his unique background as both the youngest Certified Financial Planner (CFP®) in history schooled in the fiduciary investment business, as well as life insurance practitioner consistently ranked in the top 1% of the industry. He’s a recognized expert in applying Prudent Investor principles to life insurance product selection and portfolio management serving as subadvisor to thousands of life insurance trusts. Barry has written articles for numerous national publications and has delivered continuing education to attorneys, CFP®s, CPAs, and CTFAs on the management of life insurance as an asset according to established and proven asset management principles.

Here is his commentary:

## **EXECUTIVE SUMMARY:**

Life insurance is among the last asset types to be brought under the wealth management process. For this reason, it is often the most-neglected asset in the planning of the estate and financial planner and on clients’ balances sheets. As with most other things, neglect breeds poor performance. It, therefore, comes as no surprise that life insurance has been among the worst-performing asset types relative to clients' expectations for decades.

This is not to say that life insurance has performed poorly relative to performance benchmarks for the asset-classes of invested assets underlying policy cash values. To the contrary, the performance of invested assets underlying policy cash values are quite consistent with the performance of other like-asset-class investments found outside life insurance. As such, disappointment has more to do with overly-optimistic expectations than actual under-performance.

This is because the life insurance industry's operating principles were never designed to deliver on expected performance. Instead, the industry's operating system (O/S) was designed to build and sell new products, as evidenced by the primary “output option” being illustrations of hypothetical policy values, and prevailing sales practices to compare such sales proposals for a new product to illustrations for an inforce policy as supposed due diligence and decision support.

As we will see, such illustration comparisons too often involve presenting new products using overly-optimistic assumptions in comparison to an inforce illustration too often reflecting less than realistic assumptions. For instance, in the 1980s, universal life (UL) products were generally illustrated to offer rates of return assumed to be superior to whole life (WL) products, even though both products are required by regulation to invest predominantly in the same asset classes, and thus will generally perform similarly over time.

In the 1990s, variable life (VL) products were again too often illustrated using overly-optimistic rates of return in comparison to UL products that by then were being illustrated to reflect reduced rates of return that were unrealistically even lower than historical rates of return for the corresponding asset classes into which they are required to invest. In both cases, such illustration comparisons for the “flavor of the day” product failed to examine internal costs, obfuscated excessive charging with overly-optimistic performance assumptions, and consistently produced disappointing results.

As such, disappointing performance has less to do with actual performance of life insurance products relative to other like-asset-classes, and more to do with over-reliance on a product-centric operating system (O/S) designed to build and present products that appear attractive in the environment at the point of sale, but which fail to incorporate established asset management principles proven effective over time. The West Point Draft of Best Practices Standards will be discussed hereafter as a more client-centric alternative for the prudent selection/retention and proper management of life insurance as an asset.

## FACTS:

### Out-Dated Operating System (O/S) – A Case Study

In re: Cochran v. KeyBank shows how the product-centric life insurance industry O/S proved effective for selling new “flavor of the day” products but produced disappointing results. For more detail, see LISI Newsletters #1486 and #1499 published 29-Jun-09 and 05-Aug-09, respectively. As such, this case offers insights for estate and financial planners, life insurance fiduciaries, and life insurance advisors who wish to distinguish their practice as client-centric and advice-oriented.

For instance, when interest rates were at lifetime highs in the 1980s, the life insurance industry developed a new product called universal life (UL) specifically designed to appear attractive in periods of high interest rates. Accordingly, Stuart Cochran created an irrevocable life insurance trust (ILIT) in the mid-1980s to own \$4.75M of UL and similar products where cash values are required by regulation as a practical matter to be invested predominantly in conservative asset classes like high-grade corporate bonds and government-backed mortgages.

Some years later, as prevailing interest rates declined, and the Dot-Com boom of the 1990s drove the stock market to all-time highs, the life insurance industry developed another new product called variable universal life (VUL) designed to appear attractive when client confidence in the stock market is high. With Cochran’s UL policy under-performing original (albeit unrealistic) expectations, Cochran’s agent recommended replacing the original \$4.75M policies with an \$8M VUL policy using comparisons of hypothetical illustrations showing a \$3M+ increase in death benefits “for no additional cost” and allocated cash values predominantly to aggressive asset classes.

With the stock market crash in the early 2000s, the life insurance industry developed another new product called guaranteed universal life (GUL) designed to appear attractive in periods of financial uncertainty. Accordingly, Cochran’s VUL cash values declined by \$37,000 – a 7% unrealized loss. Even though a 7% loss is well within the expected range of returns for an aggressive asset allocation, Cochran’s life insurance agent nonetheless recommended replacing the \$8M VUL with a \$2.5M GUL policy in response to this “unexpected” loss, and again compared

illustrations of hypothetical policy performance as decision-support for this recommendation.

Ironically, the VUL-to-GUL exchange was “recommended” to protect trust assets from further stock market declines, but actually incurred a 20% realized loss due to a \$107,000 surrender charge. Had the VUL policy been maintained, the 7% unrealized loss would have rebounded since the stock market recovered as it always does. Alternatively, if an aggressive asset allocation was no longer consistent with the appropriate risk profile (if it ever actually was), then market risk could have been eliminated by simply reallocating cash values to the policy’s fixed account. Neither option was considered due to life insurance industry O/S over-reliance on illustration comparisons.

Seven months after this 3<sup>rd</sup> exchange in just 16 years, Mr. Cochran died and beneficiaries received \$5.5M less than expected, and \$3M+ less than originally intended. While each of these products offer features and benefits useful in certain client circumstances and planning situations, the Cochran case exemplifies the problems that can arise when financial and estate planning professionals look for advice on the prudent selection/retention and proper management of life insurance from an industry whose operating principles are not designed to advise, and instead are designed to build and sell “flavor of the day” products.

Indeed, Cochran v. KeyBank shows both how illustration comparisons can be an effective sales tool but also how such illustration comparisons fail to disclose costs and/or reflect reasonable investment performance relative to acceptable risk (e.g., as shown by the UL-to-VUL exchange). For these reasons, comparisons of illustrations of hypothetical policy values are now considered “misleading”, “fundamentally inappropriate”, and unreliable by financial, insurance and banking industry authorities. In other words, the information essential to advice — such as cost disclosures and historical performance — is not even an “output option” from the life-insurance-industry O/S.

Imagine trying to advise anyone about anything without knowing what is actually being charged and what is reasonable to expect in performance, and where decision-support is based on “misleading”, “fundamentally inappropriate”, and unreliable information. It’s, therefore, no surprise that life insurance has been among the worst-performing asset types relative to

clients' expectations, and that financial and estate planners have struggled to understand how life insurance fits into their financial and estate plans and/or resisted considering life insurance as a planning tool altogether.

### **Prudent Investor Operating System (O/S) for Life Insurance**

On the other hand, the advice industry has its own “operating system”, which I call the Prudent Investor operating system. Advice differs from product sales in that advice follows an established decision-making framework that’s been tested in the courts and proven reliable over almost 200 years. Examples of a Prudent Investor O/S include ERISA for retirement plans, the Uniform Prudent Investor Act (UPIA) for private trusts (to include life insurance trusts), and fiduciary standards for investment advisors, trustees and investment committee members.

The Prudent Investor O/S was also recently “expanded” to address life insurance in the West Point Draft of Best Practice Standards for Life Insurance Stewardship using the same universal decision-making framework already widely-accepted in the investment business. As such, financial and estate planners and life insurance fiduciaries now have a familiar decision-making framework to also understand how life insurance fits into their planning and what to reasonably expect.

The evolution from the outmoded life insurance industry O/S to the Prudent Investor O/S is being fueled by the same mega-forces that transformed the investment business decades ago, namely the advent of new standards of care, the invention of new tools and services to support new duties, and enforcement by regulators and litigators. The result was greater transparency, lower costs, and better performance.

Some readers will remember when the investment business used to look a lot like the life insurance business of today, when investments were sold by “financial advisors” based on hypothetical projections (e.g., tax shelters) instead of empirical research for costs and performance, when “advice” was generally bundled with and incidental to a sale of some product and often non-existent after the sale, and when “Investment Contracts” paid up-front commissions on the placement of some product (as much as 50% and more in some cases) rather than fees for advice, management, and results over time.



The evolution of the investment business we know today began with ERISA providing a set of rules (i.e., the new operating system) for a substantial portion of the industry (i.e., Qualified Retirement Plans). While ERISA didn't apply to the entire investment industry, these new rules made enough sense and applied to enough of the industry that this new O/S spread to much of the rest of the investment business. These new rules included 1) the duty to monitor, 2) the duty to investigate suitability, and 3) the duty to manage as a "Prudent Man" would to minimize costs and maximize benefits relative to acceptable levels of risk.

In the years following ERISA, third-party administrations (TPAs) developed record-keeping systems to support this duty to monitor, and research providers began publishing pricing and performance data to support the duty to investigate. Such ready access to information about current holdings and their prudence relative to peer-group products also lead regulators and litigators to enforce this standard-of-care.

For instance, whereas there was comparatively little litigation in the investment business before ERISA, Qualified Plan Trustees were the popular target of litigation involving breach of the duties prescribed by ERISA in the late 1980s and early 1990s. As such, ERISA set into motion three mega-forces:

- 1) Third-Party Administrators (TPAs) providing information about current holdings,
- 2) Research services publishing suitability information relative to peer-group products, and
- 3) Regulators and litigators using #1 and #2 to enforce the rules prescribed by ERISA.

The combined effect of these mega-forces transformed the investment industry from a product-centered, "manufacturers'-rep" business into a client-centered, advice-oriented business in which more and different types of advisors entered the investment advisory business. At this same time, the Baby Boom Generation was moving into its peak earnings and savings years, substantially increasing the demand for investment products, management and advice.

Just as ERISA provided an O/S for a substantial portion of the investment industry, the Uniform Prudent Investor Act (UPIA) similarly provides a set of rules (i.e., operating system) for a substantial portion of the life insurance business, namely Irrevocable Life Insurance Trusts (ILITs). These rules under UPIA have been adopted by 40+ States/Territories and similarly include 1) the duty to monitor, 2) the duty to investigate suitability, and 3) the duty to manage as a “Prudent Man” would to minimize costs and maximize benefits relative to acceptable levels of risk.

In a repeat of events following ERISA, third-party administrations (TPAs) arrived on the scene roughly coincident with the adoption of UPIA beginning in 1994 (e.g., TrustBuilder in 1992, Resource Insurance Consultants in 2000, and ITM-21<sup>st</sup> originally founded as Advicon in 2003). Then, again in parallel fashion, life insurance product research became available some years after the arrival of TPAs (e.g., Veralytic originally founded as THEInsuranceAdvior.COM was granted the first of its patents in 2002 and made pricing and performance research and product ratings available online in 2003).

Lastly, reminiscent again of the evolution in the investment business, regulations now consider prevailing practices under the life insurance industry O/S to be “misleading”, “fundamentally inappropriate”, and unreliable, and litigation against both irrevocable life insurance trust (ILIT) trustees (e.g., Cochran v. KeyBank and French v. Wachovia) and life insurance advisors (e.g., Vagelos v. Merrill Lynch and Nacchio v. AYCO/Goldman Sachs) are beginning to enforce the rules under UPIA.

In other words, UPIA similarly set into motion the same transformational mega-forces on the life insurance business where:

- 1) Third-Party Administrators (TPAs) provide information about current holdings,
- 2) Research services publish suitability information relative to peer-group products, and
- 3) Regulators and litigators use #1 and #2 to enforce the rules prescribed by UPIA.

The combined effect of these mega-forces is driving an evolution of the life insurance business from a product-centered “manufacturers’-rep” business once the exclusive domain of agents and brokers, into a more

client-focused advisory-business where fee-based advisors and consultants are playing an increasing larger role. In response, the Financial Planning Association (FPA), recognizing the need for a universal decision-making framework for the prudent selection/retention and proper management of life insurance like that already widely-accepted in the investment business, lead in the formation of a task force that convened at West Point in 2013.

The task force was comprised of leaders from nearly every profession who have clients who own life insurance, to include representatives from one of the largest trusts and estates law practices, the largest administrator of trust-owned life insurance for institutional trustees, the largest association of financial planners, a leading university in financial planning education, several of the largest independent life insurance distributors, and several fee-based advisory firms. The result is the West Point Draft of Best Practice Standards for Life Insurance Stewardship.

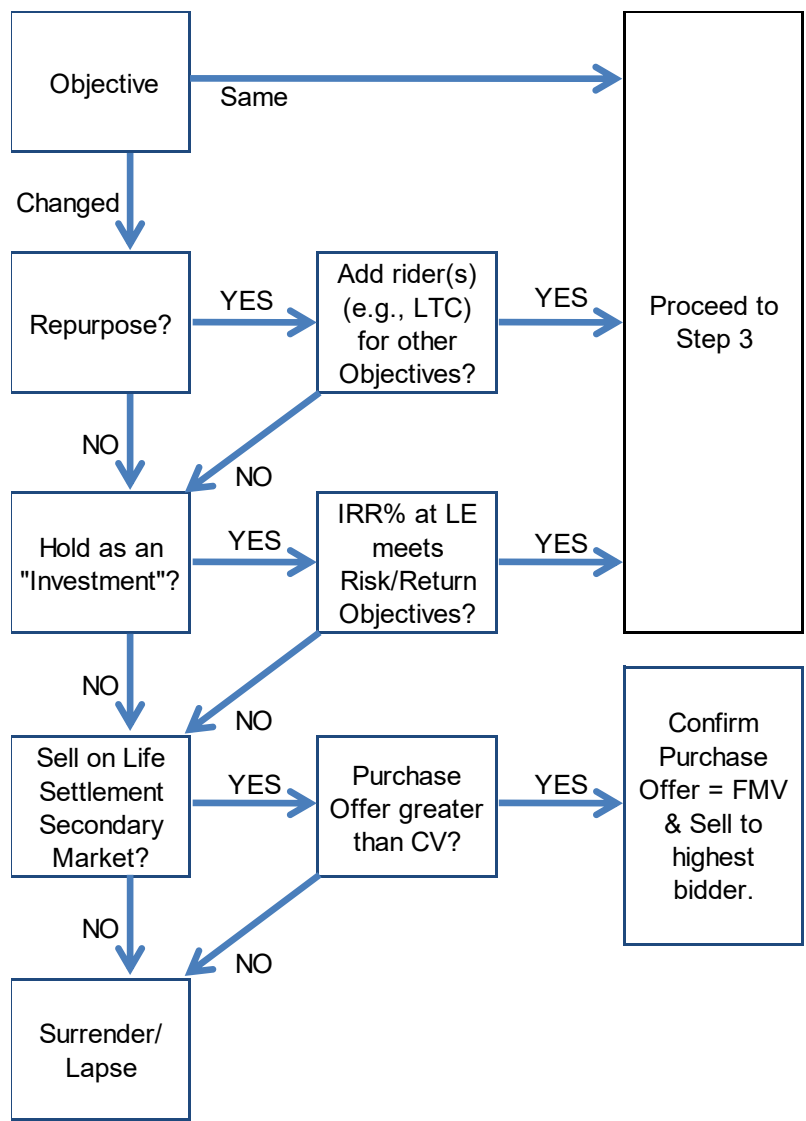
The elements of such a Prudent Investor O/S generally include 1) defining roles and responsibilities for members of the planning team, 2) analyzing goals and objectives, 3) strategizing the most prudent solutions sets (i.e. product types), 4) formalizing the search criteria for the product within the optimal solution set, 5) searching for and implementing the vehicle(s) offering best-available rates and terms (BART), and 6) monitoring performance relative to both original expectations and peer-group alternatives. The West Point Draft of Best Practice Standards is comprised of the same 6 steps, as follows.

**Step 1 - Define:** Just as the investment advisor is a member of the planning team, life insurance advisors distinguish themselves as advisors by first discussing their role and responsibilities on the planning team. Too often, conversations about life insurance start with hypothetical illustrations for some product or products. Instead, starting the conversation by defining roles and responsibilities in the planning process distinguishes the life insurance advisor from life insurance sales people, leads to better working relationships between the banker, CPA, attorney, trust officer, etc. members of the planning team, and ensures client's best interests are served.

**Step 2 - Analyze:** In the same way that investments for clients seeking income will be different from the investments for clients seeking growth,

different life insurance products are also designed for different risk profiles, asset allocations, time horizons, and expected outcomes. In addition, some life insurance products are designed for defined contributions and maximum accumulation, whereas others are designed to minimize premiums for a defined death benefit, and some are designed for both. As such, advising clients about the prudent selection/retention and proper management of life insurance requires an analysis and understanding of their circumstances, goals and objectives.

See below flowchart of an example decision tree for analyzing existing life insurance holdings in response to changing planning objectives.



**Step 3 - Strategize:** The rate of return reasonable to expect from any financial strategy is most influenced by its underlying asset allocation. Different life insurance product types are thus most significantly differentiated by their investments underlying policy cash values. For instance, most universal life (UL) and whole life (WL) products are required by regulation as a practical matter to invest assets underlying policy cash values predominantly in high-grade bonds and government-backed mortgages whereas variable products (VL) allow for allocation across various asset classes.

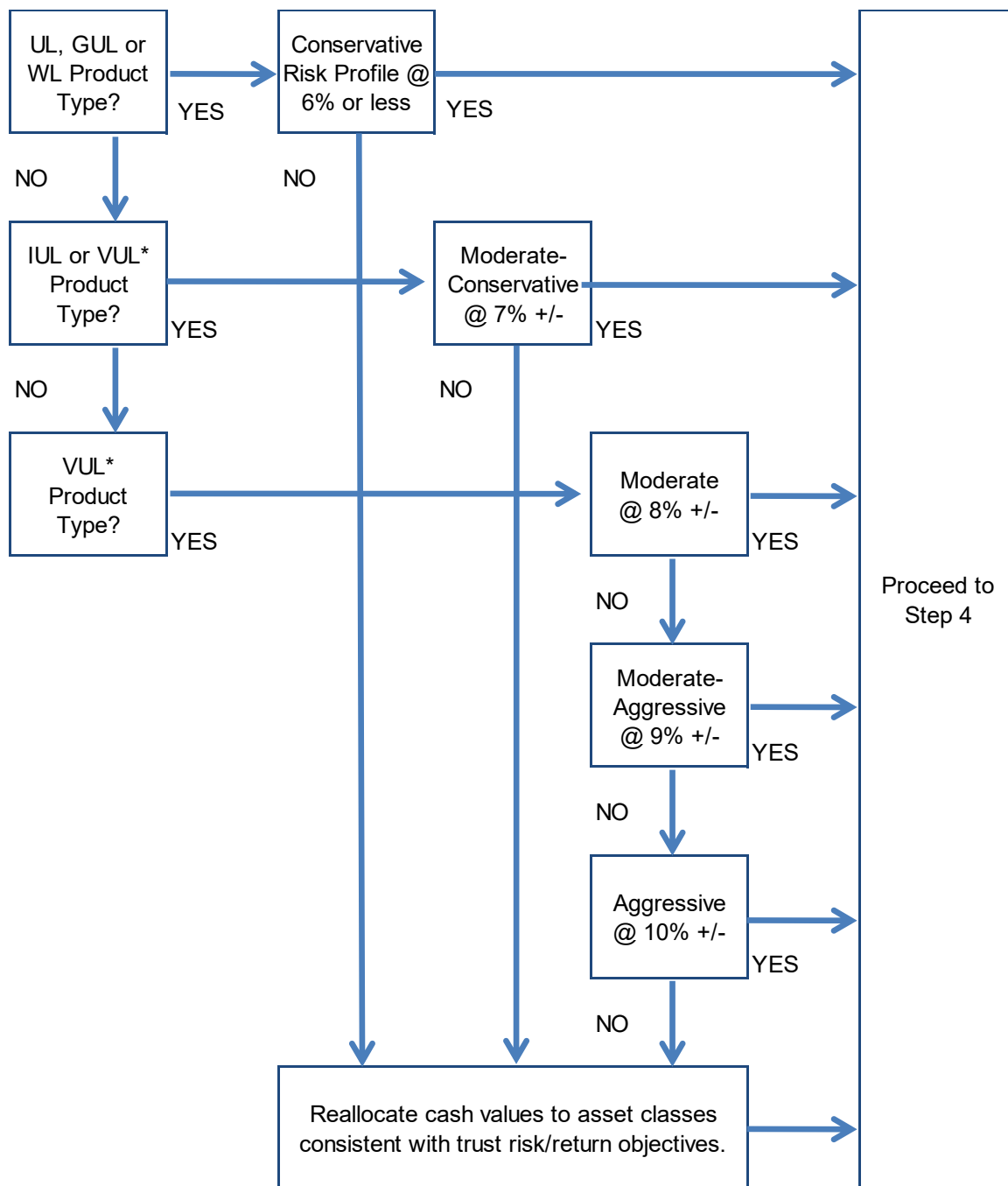
As such, the most prudent product type for a given client situation is a function of the **R**isk tolerances of the client, the corresponding **A**sset class preferences, the **T**ime horizon and the **E**xpected outcomes (remember R.A.T.E.), as follows:

Risk Profile	Asset Allocation (Equities/Fixed-Income)	Product Type	Rates of Return Reasonable to Expect
Conservative	20% / 80%	UL/GUL/WL	5% - 6%
Moderate-Conservative	40% / 60%	IUL/VUL	6% - 7%
Moderate	60% / 40%	VUL	7% - 8%
Moderate-Aggressive	80% / 20%	VUL	8% - 9%
Aggressive	100% / 0%	VUL	9% - 10%

Volatility is another consideration in determining the prudence of a given product type and the rate of return reasonable to expect. For instance, an Aggressive allocation historically produces higher rates of return over the long-term, but also a wider range of expected returns and possibly even negative returns over the short-term. As such, more Aggressive allocations also involve risk that cash values will be “sold at a loss” to cover monthly deductions for cost of insurance charges and policy expenses, thereby adversely impacting the rate of return that is reasonable to expect.

Monte Carlo simulations are useful in quantifying such adverse impact of volatility, and the corresponding risk of a “premium call” due to volatility, where the probability a policy will lapse without value and without paying a claim unless addition premiums are paid is calculated in thousand(s) of separate trial runs using different and randomly-selected rate of return assumptions. Understanding the probability of a “premium call” is essential to determining the product type that is prudent for the given client risk profile.

See below flowchart of an example decision-tree for identifying the product types appropriate to the various risk profiles.



\* VUL cash value allocations that historically produce the approximate target rates of return corresponding to each risk profile are as follows:

- Moderate-Conservative: 40% equity/60% fixed
- Moderate: 60% equity/40% fixed
- Moderate-Aggressive: 80% equity/20% fixed
- Aggressive: 100% equity/0% fixed

Source: Morningstar

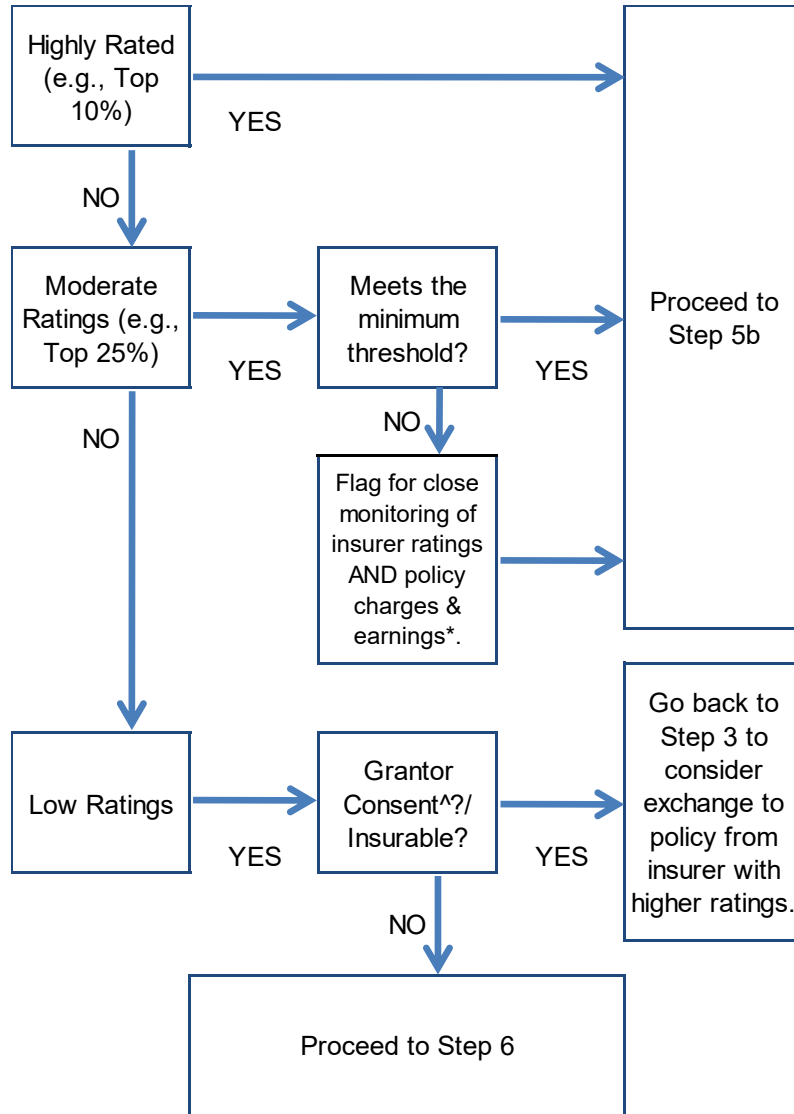
**Step 4 - Formalize:** The life insurance industry is full of constraints and conflicts (i.e., not unlike the investment business of decades ago). With 10,000+ pricing combinations and permutations for every product, cost of insurance charges (COIs) being the largest expense (not commissions), and as much as an 80% variance between best-available rates and terms (BART) and worst-available rates and terms (WART), no insurer, product, compensation model, distribution system, nor proprietary product is inherently “better” for all clients or all situations.

Understand the universe of products for the product-type peer-group identified in Step 3, ask the life insurance advisor about constraints (e.g., agents/brokers not properly licensed to discuss and place whichever product type is identified in Step 3, distribution systems that limit product availability to only or mostly proprietary products, fee-only advisors limited to a handful of products offering no/low sales-loads but potentially higher COIs, etc.), and conflicts (e.g., higher commissions for placement of some product than other products, special payments for placement of proprietary products, fees charged for some products but not for other products, reward trips, etc.) and discuss reconciling and resolving such constraints and conflicts.

**Step 5 - Implement:** A search for best-available rates and terms (BART) considers at least the financial strength and claims-paying ability of the insurer, the competitiveness of internal policy charges, the stability of the insurer’s pricing representations, restrictions on access to policy account values, and the historical performance of invested assets underlying policy cash values. Investigating such discrete product attributes also avoids hypothetical illustration comparisons now considered “misleading”, “fundamentally inappropriate”, and unreliable by financial, insurance, and banking industry authorities. Additional considerations for prudent implementation can be underwriting capabilities and ongoing service and reporting.

See below flowchart showing an example decision-tree of a search for best-available rates and terms.

### 5a – Financial Strength and Claims-Paying Ability

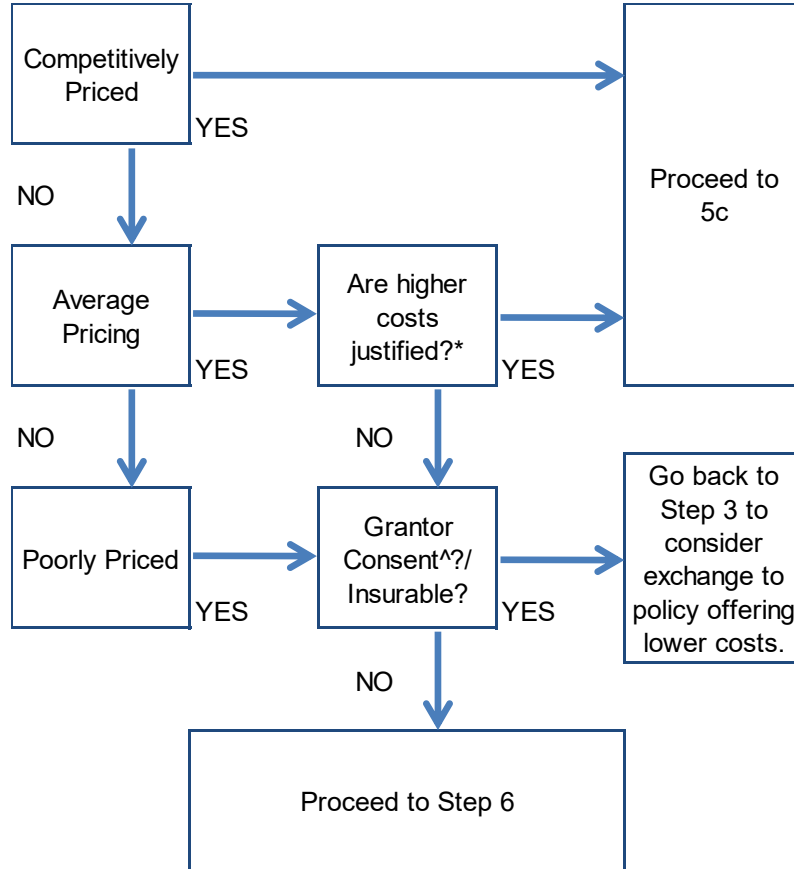


\*When an insurer's rating is downgraded, the change often means either the insurer's profitability has declined, or the insurer's reserves have deteriorated, or both. The insurer's most immediate response to a downgrade in its ratings, and its most effective means for restoring profitability and recovering reserves, can be to increase policy costs for cost of insurance (COI) charges and expenses and/or decrease interest/earnings credited to policy cash values. In other words, when ratings go down, policy charges are more likely to be increased and/or policy interest/earnings are more likely to be decreased, and thus premiums are likely to (need to) go up. As such, it can be important to measure what is actually being charged and what is actually being earned from invested assets underlying policy cash values for insurers with lower financial strength and claims-paying ability ratings.

^Grantor Consent refers to the grantor's consent to participate in the underwriting process.



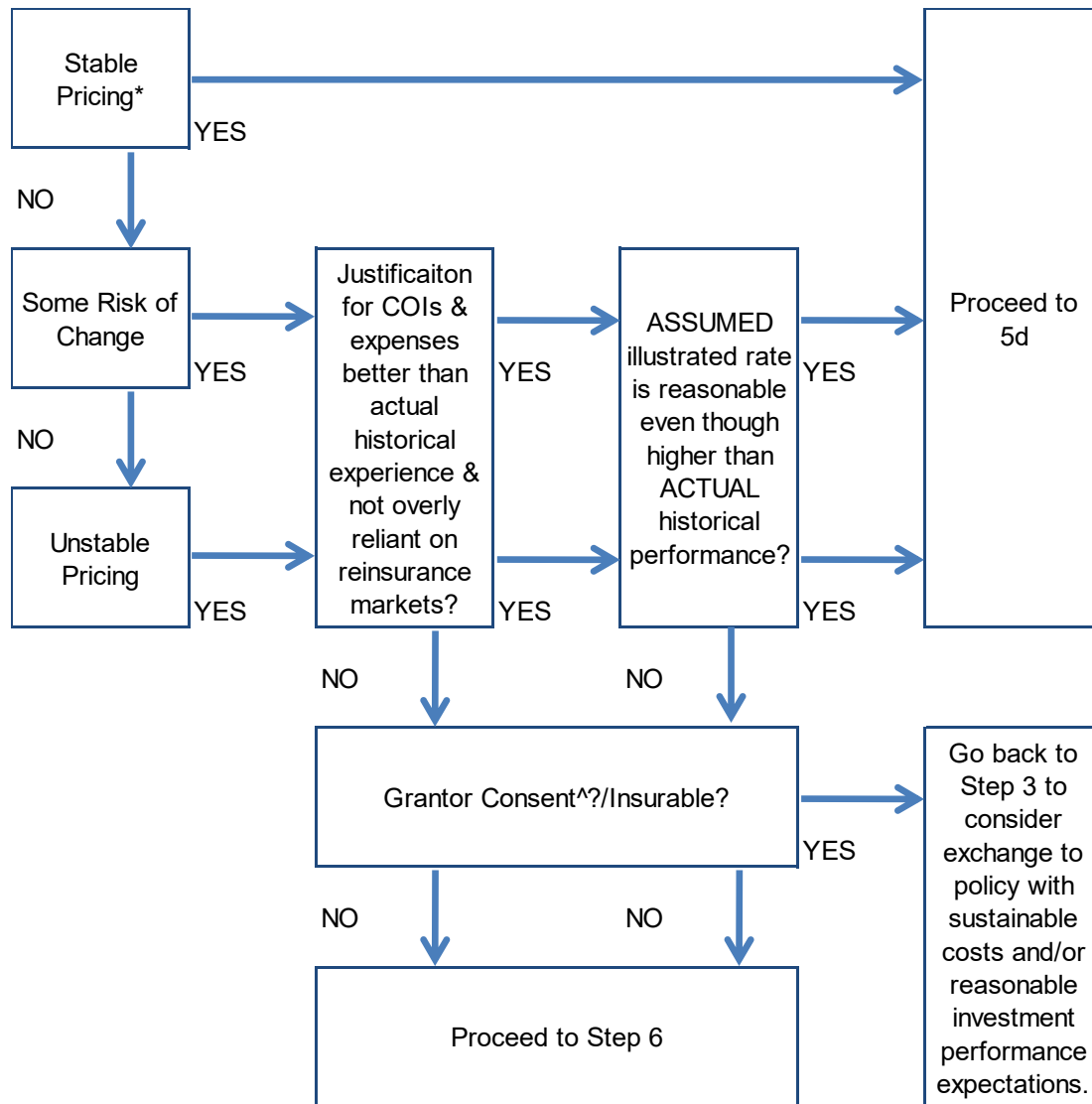
## 5b – Cost Competitiveness



\* UPIA Section 7 prescribes fiduciaries "may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee." As such, if cost of insurance charges (COIs), fixed administration expenses (FAEs), cash-value-based "wrap fees" (e.g., VUL M&Es) and/or premium loads are higher than that generally-available in the marketplace, then trustees should either: 1) document the reasons for paying higher costs (e.g., very high ratings for financial strength and claims-paying ability, very stable pricing, very high cash value liquidity, superior performance of invested assets underlying policy cash values, etc.) or 2) consider activities to reduce costs.

^Grantor Consent refers to the grantor's consent to participate in the underwriting process.

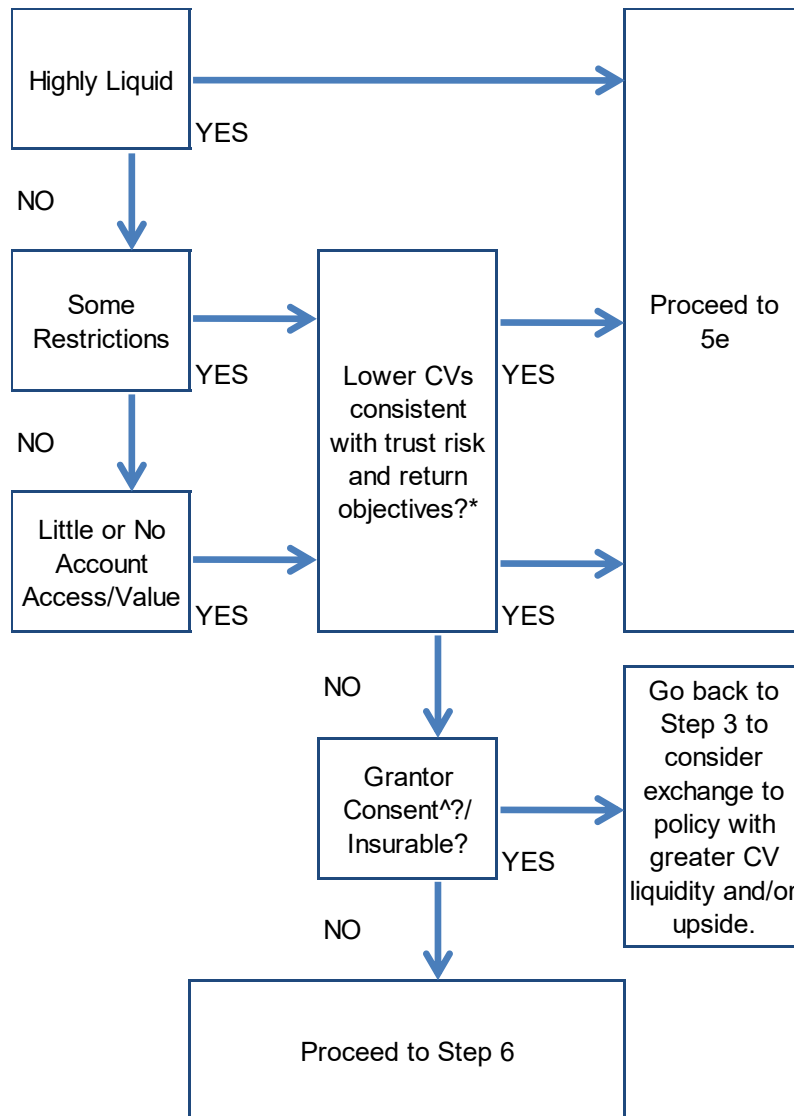
## 5c – Pricing Stability



\* e.g., pricing that is consistent with the insurer's actual historical mortality experience, operating experience, and investment experience.

^Grantor Consent refers to the grantor's consent to participate in the underwriting process.

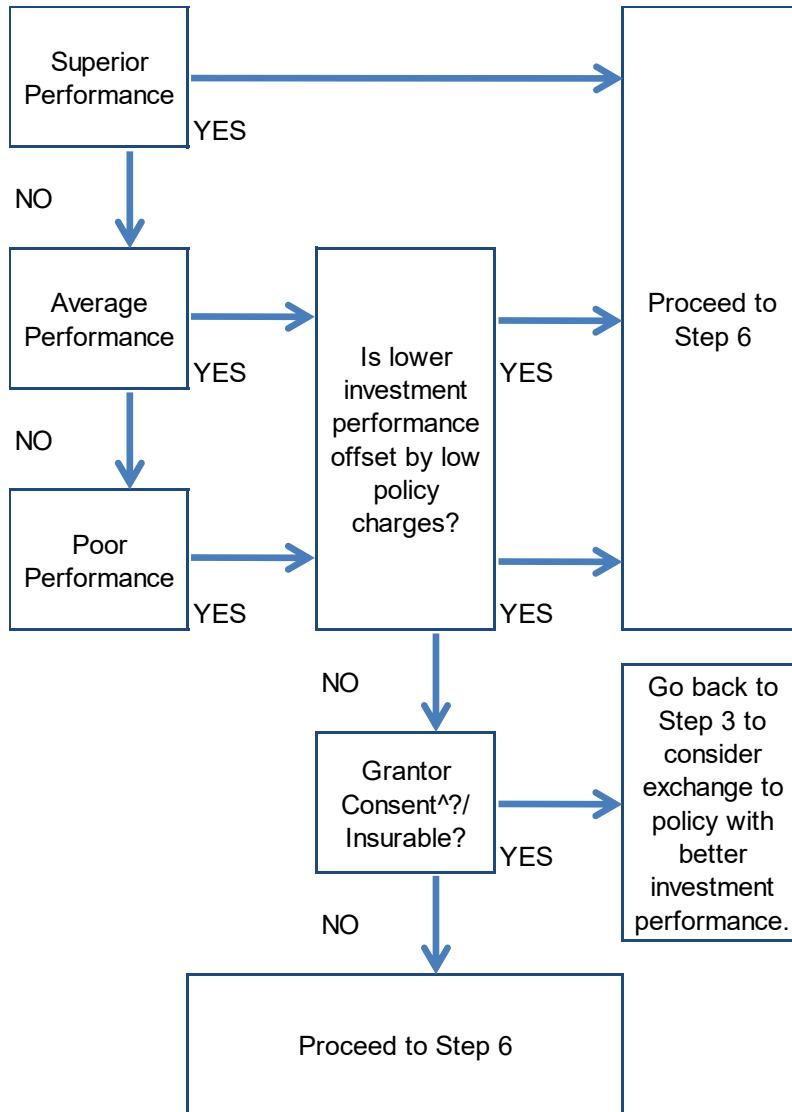
## 5d – Relative Account Liquidity



\* Cash Values can be relevant to trust objectives when an objective of the trust is to 1) accumulate wealth for a specific reason like retirement, 2) pay future cost of insurance charges (COIs) and policy expenses, and/or 3) seek higher interest/earnings rates on invested assets underlying policy cash values to the extent consistent with trust risk/return parameters. In the absence of the above or other reasons that cash values would be relevant to trust objectives, policies with lower or even no cash values can be suitable. While a policy with cash values is considered more suitable than a policy without cash values WHEN ALL OTHER POLICY ATTRIBUTES ARE EQUAL, a policy without cash values can be more suitable than a policy with cash values if/when the policy without cash values offers some other advantage over the policy with cash values. For instance, term life insurance (e.g., LT10) products have no cash value, but offer a much lower premium than policies with cash values. Similarly, guaranteed universal life (i.e., GUL) products often have little to no cash values, and to the extent premium requirements are lower than the premium requirements for a product with cash values, then a GUL product can be more suitable than a product with cash values.

^Grantor Consent refers to the grantor's consent to participate in the underwriting process.

## 5e – Historical Performance



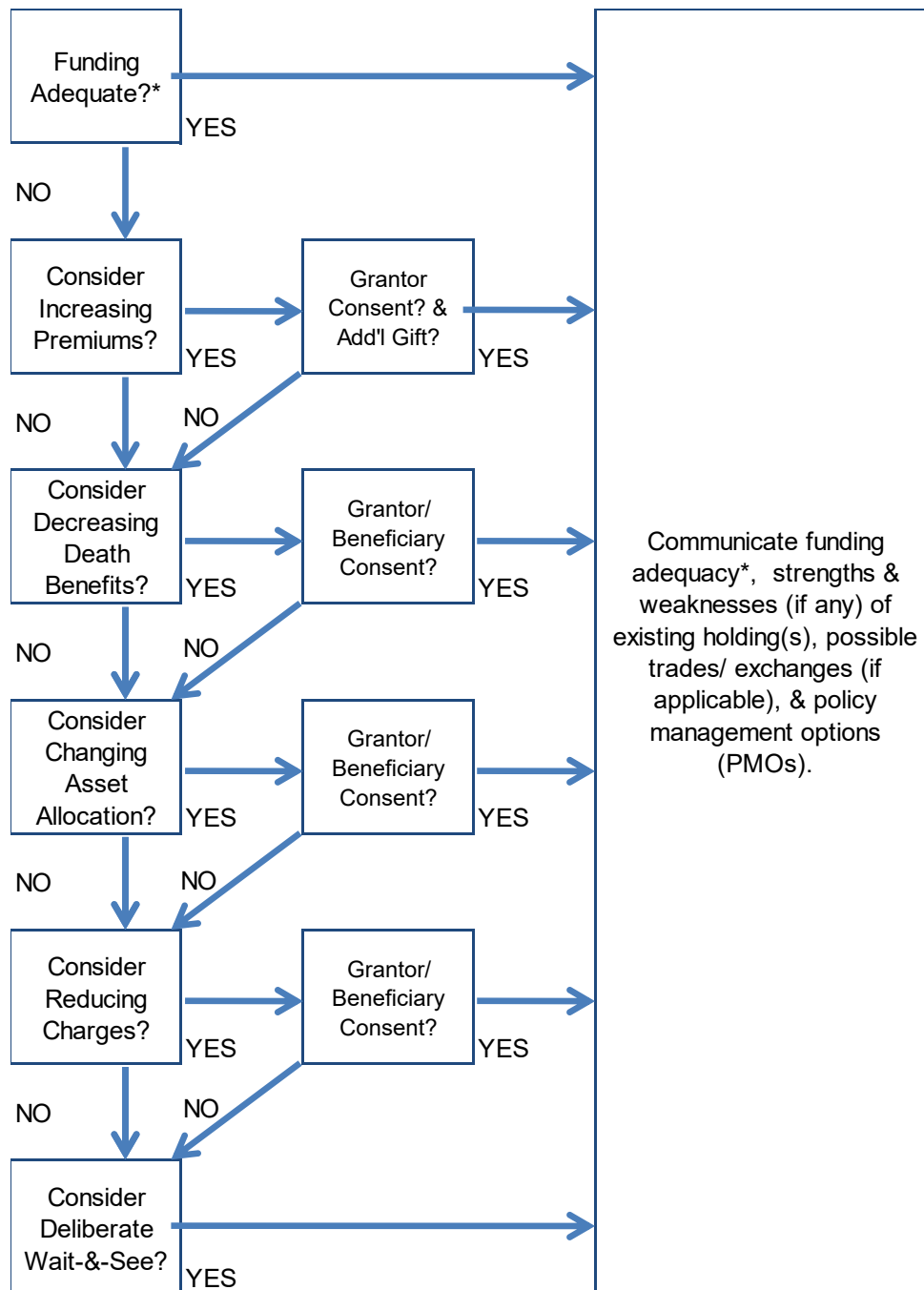
\* UPIA Section 2(b)(5) prescribes that fiduciaries “shall consider ... the expected total return [from the] overall investment strategy having risk and return objectives reasonably suited to the trust.” While past performance is no guarantee of future results, using actual historical performance is generally-accepted as a useful measure of expected future performance. Because illustrations of HYPOTHETICAL policy values are NOT required to illustrate an assumed rate of return that is correlated with actual historical performance of invested assets underlying policy cash values, it is particularly important for fiduciaries to separately consider the expected return on invested assets underlying policy cash values.

^Grantor Consent refers to the grantor's consent to participate in the underwriting process.

**Step 6 - Monitor:** Life insurance has been among the most disappointing asset types relative to client expectations for decades due in part to lack of monitoring, reporting, and management. Advising clients about the prudent selection/retention and proper management of life insurance, therefore, involves periodically checking on changes in the health, risk tolerance, time horizon, performance expectations and/or planning objectives of the client, changes in the financial stability and claim-paying ability of the insurer, and/or changes in internal costs, investment performance, and/or the funding adequacy of policy holdings. Only with such information can policies be prudently managed as follows:

<b>Portfolio Management Option</b>	<b>Under-funded Policies</b>	<b>Over-funded Policies</b>
PMO #1: Change Premiums	Increase premiums to increase cash values in amounts necessary to cover policy costs over the intended coverage duration.	Reduce premiums or refund cash values no longer necessary to cover policy costs over the intended coverage duration.
PMO #2: Change Benefits	Reduce benefits to reduce costs such that existing cash values and planned premiums can cover reduced costs over the intended coverage duration.	Increase benefits using excess cash values to cover costs of increased benefits over the intended coverage duration.
PMO #3: Change Cash Value Allocation / Expected Rate of Return	Re-allocate to more aggressive asset classes with a historically higher expected rate of return in an effort to increase cash values needed to cover policy costs over the intended coverage duration, albeit with greater volatility/risk of loss.	Re-allocate to more conservative asset classes to reduce volatility and minimize the risk of a "premium call" otherwise needed to cover policy costs over the intended coverage duration.
PMO #4: Change Policy Costs	Reduce excessive costs such that existing cash values and planned premiums are better able to cover the cost of intended benefits over the intended coverage duration.	Reduce excessive costs such premiums can be reduced, cash values can be refunded, benefits can be increased, and/or cash values can be reallocated to more conservative asset classes.
PMO #5: Coverage Duration	Consider "wait & see" where cash values are sufficient to support policy costs for a reasonable period, where policy costs are competitive, where interest/earnings are within the expected range of returns even if below the target rate of return, and there is no looming risk of a lapse.	N/A

See below flowchart showing an example decision-tree for the above portfolio management options (PMOs).



\* Funding Adequacy refers to the degree to which existing policy cash values and planned premiums are sufficient to pay future cost of insurance charges (COIs), fixed administration expenses (FAEs), cash-value-based "wrap fees" (e.g., VUL M&Es) and/or premium loads over the intended duration of the policy contract. If a policy is intended to provide a permanent death benefit, then funding adequacy means cash values and planned premiums are sufficient to pay cost of insurance charges (COIs) and policy expenses to contract maturity (i.e., typically either age 100 or age 120). However, if the intended coverage duration is less than permanent (e.g., in the case of an insured in declining health where life expectancy is believed to be shorter than that for a health insured), then funding adequacy means cash values and planned premiums are sufficient to pay cost of insurance charges (COIs) and policy expenses over this shorter period of time.

## COMMENT:

Life insurance is an essential planning tool for many financial and estate planning professionals, but remains the last, largest, most-neglected, and most-disappointing asset on clients' balance sheets and in planners' planning. At the same time, the population over age 65 is projected to double between now and 2030, and the Baby Boom Generation is expected to transfer more wealth than ever before, substantially increasing the demand for life insurance products. Given such an increase in demand, and the neglect and poor-performance of this asset to date, it's time for a new operating system for life insurance advice.

Financial and estate planners who reject the outmoded life insurance industry O/S of the past which doesn't even include a "management module", and instead adopt a Prudent Investor O/S will bring clients greater transparency, be better prepared to meet the coming demand for advice, and be more likely to lower costs, improve performance, and meet client expectations. The West Point Draft of Best Practice Standards for life insurance is just such a Prudent Investor O/S based on the same established, proven, and universal decision-making framework widely-accepted in the investment business.

**HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!**

*Barry Flagg*

## CITE AS:

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## Data Entry

Product ID: Variable Universal Life

Age of First Insured: 41

Age of Second Insured: 45

Gender: Male

Gender: Female

Rating: Preferred NS

Rating: Preferred NS

Face Amount: \$ 9,500,000

Crediting Rate: 10.32 %

Premium Years: 24

Confidence Level: 90

Premium: \$ 200,000.00

COI Multiple: 114

Interest Method: Fixed

Investment Datasets: Historic 100/0

Calc Method: \$0

Investment Offset: 0

Sustain: Age 100

Scale: 1.0

### Increasing Death Benefit

First Year Extra Premium

In-Force

Withdrawals

Deviations

Apply increasing Death Benefit 10 years, to age 51 and remain Level there after.

### Increasing Death Benefit

First Year Extra Premium

In-Force

Withdrawals

Deviations

Enter the net amount to be added in year one. \$ 200,000

### Increasing Death Benefit

First Year Extra Premium

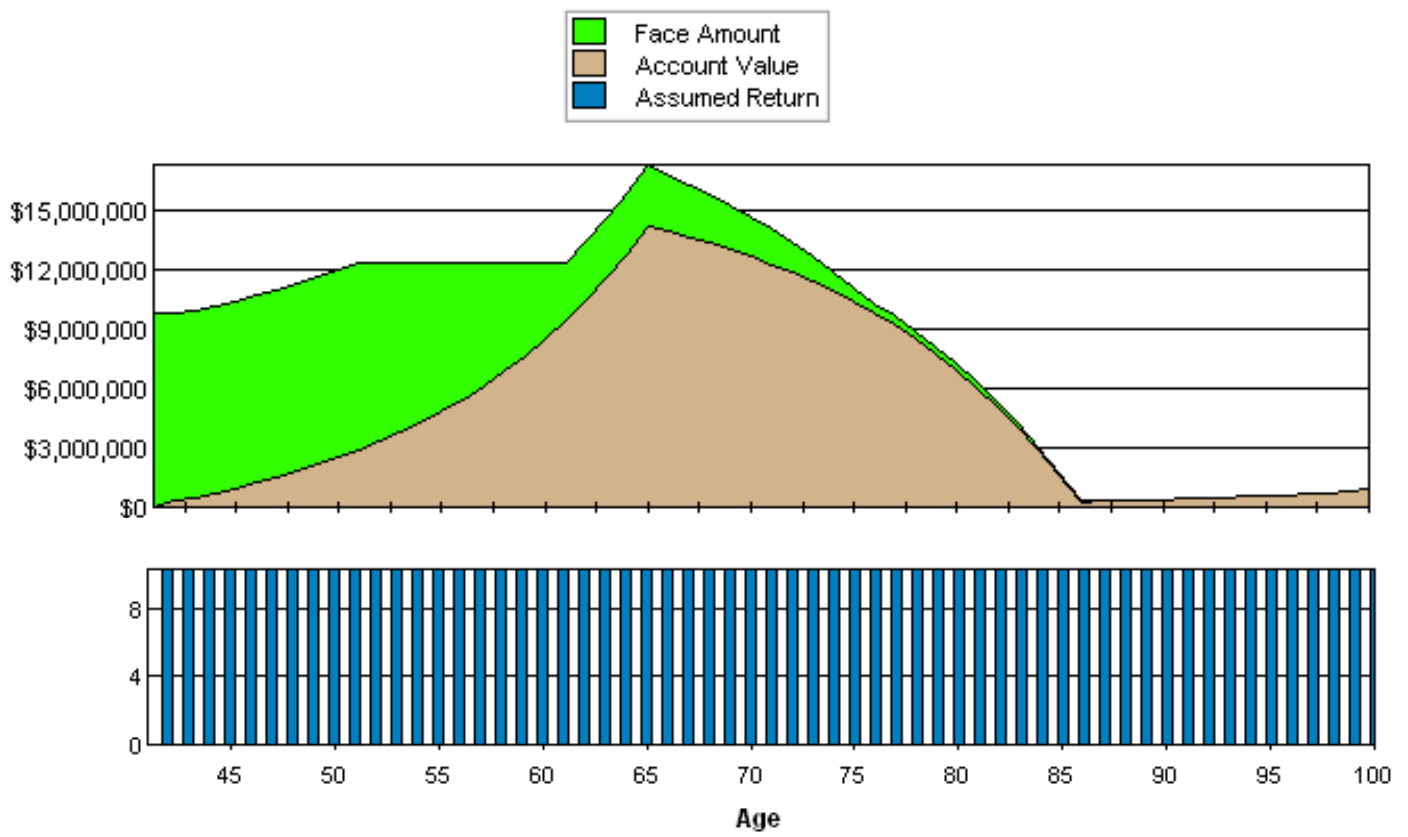
In-Force

**Withdrawals**

Deviations

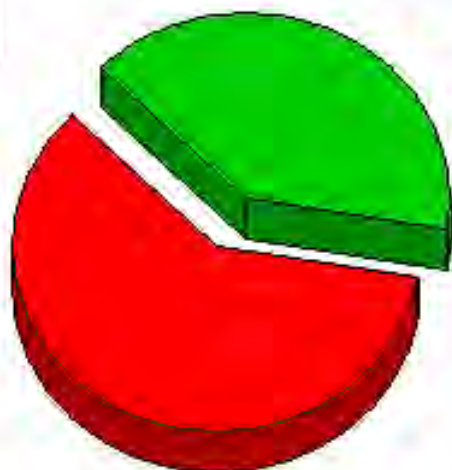
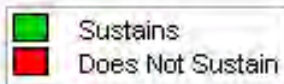
Withdraw \$ 1,500,000 annually beginning at age 65 continuing for 20 years.

Illustration input into the Historic Volatility Calculator



Matching the sales illustration as closely as possible.

## Random Trials - Variable Universal Life



Policy Specifications  
 Death Benefit: \$ 9,500,000  
 Funding Premium: \$ 200,000.00  
 Asset Allocation: Historic 100/0  
 Offset: 0

Max. 5-year Rolling Lapse Interval: 69 to 73

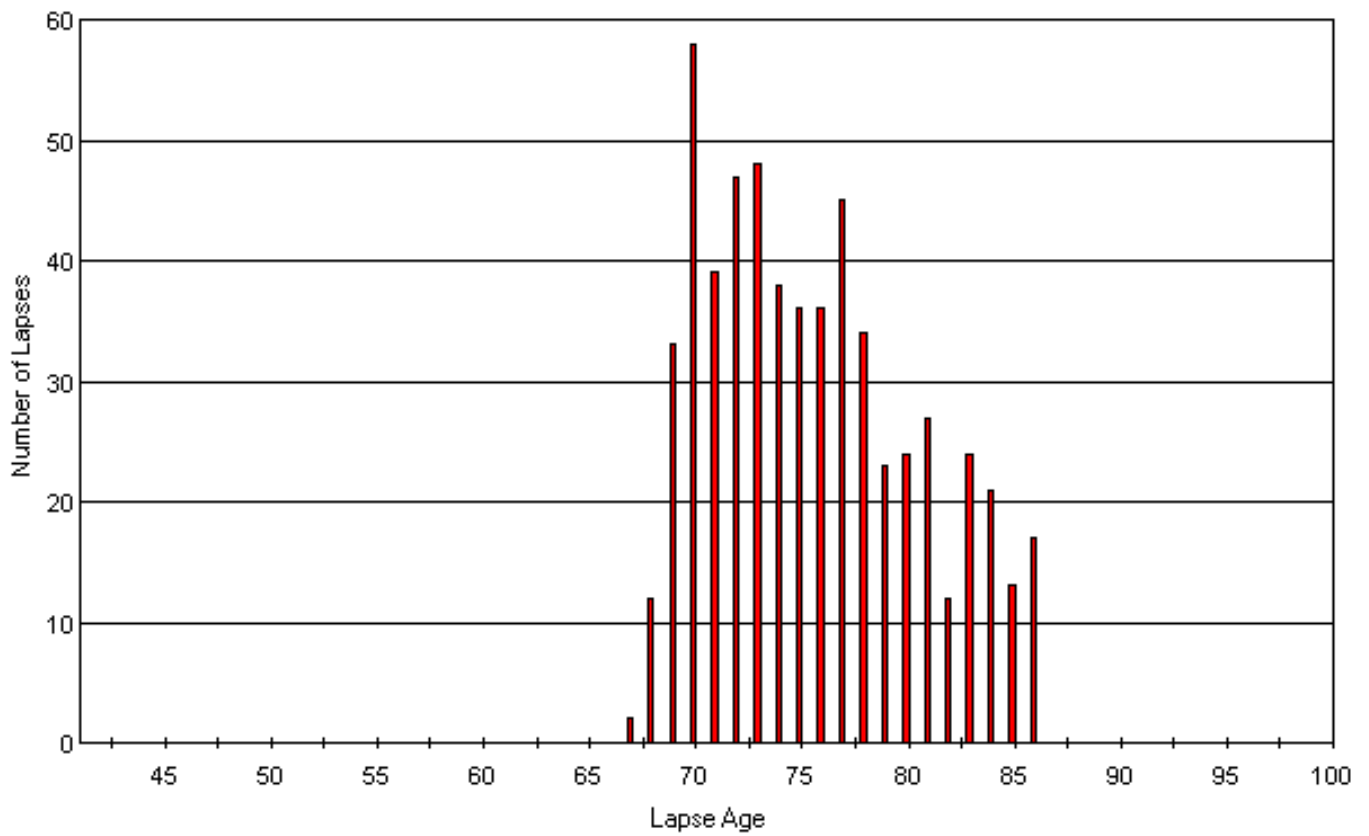
### Policy Performance Statistics

Trial Illustrations:	1,000
<b>Trials Sustaining ( 40.3 % ):</b>	403
Life Expectancy Death Benefit (Age 88):	\$ 97,625,000
Age 100 Death Benefit:	\$ 280,467,000
<b>Trials NOT Sustaining ( 59.7 % ):</b>	597
Age first Lapse:	67

### Investment Statistics

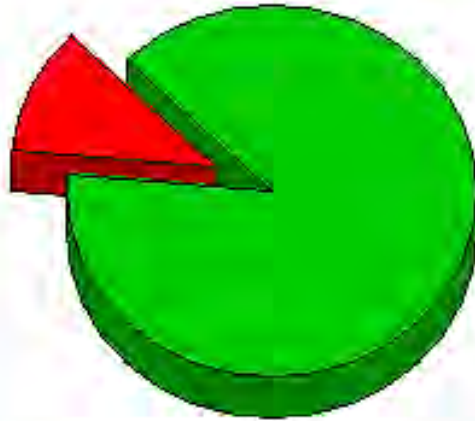
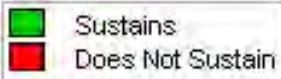
Average Arithmetic Mean: 10.64 %  
 Average Geometric Mean: 9.94 %  
 Average Standard Deviation: 15.15 %

Cash flow expectation of \$1.5M X 20 years has only a 40% probability of success.



This is the distribution of the almost 600 lapses prior to age 100. Note that as soon as withdrawals/loans exceed basis, there will be ordinary income tax assessed on the different in the year of lapse.

## Random Trials - Variable Universal Life



Policy Specifications  
 Death Benefit: \$ 9,500,000  
 Funding Premium: \$ 200,000.00  
 Asset Allocation: Historic 100/0  
 Offset: 0

Max. 5-year Rolling Lapse Interval: 76 to 80

### Policy Performance Statistics

Trial Illustrations:	1,000
<b>Trials Sustaining ( 88.9 % ):</b>	889
Life Expectancy Death Benefit (Age 88):	\$ 104,112,000
Age 100 Death Benefit:	\$ 262,027,000
<b>Trials NOT Sustaining ( 11.1 % ):</b>	111
Age first Lapse:	70

### Investment Statistics

Average Arithmetic Mean: 10.57 %  
 Average Geometric Mean: 9.86 %  
 Average Standard Deviation: 15.16 %

The cash flow would need to drop from \$1.5M X 20 years  
 To \$600,000 X 20 years to get close to 90% probability of  
 success.





# Fiduciary Life

**Synopsis:** *The Veralytic service may finally bring some semblance of transparency to the cash value life insurance marketplace.*

**Takeaways:** *Beware misleading policy illustrations, recognize that under the complexity there are a few moving parts to watch, and get a clear look at the expenses as they relate to the policy design.*

Barry Flagg, founder and CEO of the Veralytic life insurance analysis system (<http://www.veralytic.com/>), calls his firm “the Morningstar of cash value life.” But unlike Morningstar, which is able to publish clear numbers to an audience that understands what they mean, Flagg has to peel back various layers of naivety in his prospective customers when explaining the value of life insurance due diligence.

At the first layer, he says: “Most peoples’ comparison between life insurance products is to compare the premiums. But,” he adds with a bit of an edge to his voice, possibly a habit from repeating the phrase a few too many times to a few too many advisors and consumers, “the premium is NOT the cost.”

The second layer is almost as naive. Most cash value life insurance is sold by an agent showing various policy illustrations. Flagg notes that both FINRA and the insurance industry’s own Society of Actuaries have come out with statements warning that these

illustrations can be (and often are) misleading, and should not be used to compare policies.

Flagg came to this conclusion himself when he switched careers from a pension investment analyst in a culture steeped in the fiduciary mindset, to working in a high-volume Manufacturers Life insurance office in Tampa,

*Flagg very quickly discovered that analysis that was easy in the investment world was impossible with insurance.*

FL. “When I had been analyzing investments, I was using the book version of Morningstar, because the disks weren’t available yet,” he says. “You had a very clear and accurate source of data to base your recommendations on. In the insurance agency,” Flagg adds, “I very quickly discovered that what was easy in the pension investment advisory business

was literally impossible in the insurance business.”

Nor was there a culture of providing due diligence analytics to the end customer. “Many times, over the course of my career,” says Flagg, “I’ve been told: *you work way too hard just to sell life insurance policies. Just take the product you’re given and go sell it.* But that didn’t reconcile with either my internal code of ethics or my early experience with the pension investment advisory system—or, for that matter, the value system I was raised in. Finally, in 1999, I founded Veralytic to provide what was missing to fiduciaries in the investment and trust world.”

## *Crediting rate switcheroo*

If you’re skeptical about whether an insurance company would doctor up its projections just to sell policies, consider a recent illustration that Veralytic reviewed, created by the John Hancock Life company. (See graphic.). On the front page, you are told—in clear understandable english—that the illustration is based upon a 5.05% assumed crediting rate. Therefore, one might plausibly assume that you should compare the hypothetical cash buildup of this policy with a similar policy whose carrier assumes that it will earn the same 5% or so a year on the money inside the policy.

*Au contraire.* When Veralytic’s various algorithms deconstructed the year-by-year numbers used in the illustration,

Illustration Assumptions

Sample  
Male - Preferred NonSmoker  
Age: 45

Initial Death Benefit \$1,000,000  
Face Amount \$1,000,000  
Initial Planned Premium: \$8,462.00 / Billing Mode: Annual  
Death Benefit Option 1: Cash Value Accumulation Test  
State: Illinois  
Based on Current Charges and an Initial Current Rate of 5.05%

Policy Year	Planned Premium	Premium Charge	Admin/Contract Charges	Insurance Charges	Amount Credited	Policy Value	Surrender Charge	Net Surrender Value
1	8,462	1,523	2,455	237	277	4,524	10,056	0
2	8,462	1,523	2,455	456	500	9,052	9,747	0
3	8,462	1,523	2,455	587	725	13,674	9,425	4,248
4	8,462	1,523	2,455	709	955	18,403	9,113	9,290
5	8,462	1,523	2,455	814	1,191	23,263	8,812	14,451
6	8,462	1,523	2,455	904	1,524	28,367	8,513	19,854
7	8,462	1,523	2,455	1,000	1,795	33,645	6,550	27,095
8	8,462	1,523	2,455	1,107	2,075	39,097	4,449	34,648
9	8,462	1,523	2,455	1,226	2,364	44,718	2,270	42,448
10	8,462	1,523	2,455	1,361	2,662	50,502	0	50,502
<b>Totals:</b>	<b>84,620</b>	<b>15,232</b>	<b>24,552</b>	<b>8,401</b>	<b>14,067</b>			
11	8,462	1,523	2,455	1,461	2,969	56,494	0	56,494
12	8,462	1,523	2,455	1,616	3,286	62,649	0	62,649
13	8,462	1,523	2,455	1,784	3,612	68,960	0	68,960
14	8,462	1,523	2,455	1,963	3,945	75,425	0	75,425
15	8,462	1,523	2,455	2,150	4,287	82,046	0	82,046
16	8,462	1,523	2,455	2,365	4,636	88,800	0	88,800
17	8,462	1,523	2,455	2,598	4,991	95,677	0	95,677
18	8,462	1,523	2,455	2,850	5,353	102,664	0	102,664
19	8,462	1,523	2,455	3,124	5,720	109,743	0	109,743
20	8,462	1,523	2,455	3,426	6,091	116,892	0	116,892
<b>Totals:</b>	<b>169,240</b>	<b>30,463</b>	<b>49,104</b>	<b>31,738</b>	<b>58,956</b>			
21	0	0	2,455	3,824				
22	0	0	2,455	4,282				
23	0	0	2,455	4,745				
24	0	0	2,455	5,313				
25	0	0	2,455	5,964				
26	0	0	2,455	6,682				
27	0	0	2,455	7,432				
28	0	0	2,455	8,309	17,377		0	128,500
29	0	0	2,455	9,309	18,583	135,319	0	135,319
30	0	0	2,455	10,429	19,899	142,333	0	142,333
<b>Totals:</b>	<b>169,240</b>	<b>30,463</b>	<b>73,656</b>	<b>97,996</b>	<b>08</b>			

\$ 135,310 End-of-Year-29 Policy Value  
 - 2,455 Admin/Contract Charges  
 - 10,429 Insurance Charges  
 = 122,426 Policy Value earning interest

\$ 19,899 Amount Credited  
 + 122,426 Policy Value earning interest  
 - 16.3% Actual Assumed Interest Credited

This is your Basic Illustration and is valid only if all illustration pages are included.  
Version: 13.3 S[0-0-24576-3584-8192] - 212 Page 10 of 14 08/11/2017 10:15:55 AM

and compare them with industry standards and other policies that the client might be able to 1035 into.

She should be able to know the historical rate of return that the insurance policy has earned on cash values inside of its policies, compared with its peers.

She should know whether the policy is competitive and fair, how much it costs and what to expect performance-wise in the future.

And right now, Veralytic is the only service that offers this information, by dragging this data kicking and screaming from a confusing jumble of assumptions, filings and an expanding database of results from other policies it has analyzed.

*The most complicated corner of the investment world*

There's a reason why most advisors recommend only term life coverage for their clients: they can understand it. But Flagg believes that once advisors learn to appreciate the four unique tax benefits conferred on life insurance (due to tireless lobbying and bottomless lobbying budgets), they might change their mind. Death benefits are paid to heirs, even those multiple generations out, without being dinged by the estate or income tax system. The internal buildup in the policies takes place tax-free, even if you move the money around in a variable contract among different accounts. Cash values exceeding the owner's tax basis may be

a 5.05% rate, Flagg found, would have been expected to correspond to \$6,183 credited over the life of the policy. But the actual total turned out to be \$19,839.

"This illustration reflects a 16.3% crediting rate," says Flagg. The naive consumer who compared the "effectiveness" of this policy with a competitor's that would be building up at a hypothetical 5% rate would have selected the John Hancock policy hands down—and been sorely disappointed when reality fell

short of the projection.

Once you peel back the first couple of layers of naivety, you get to Flagg's algorithms and Veralytic's deep analysis of the actual numbers underpinning a cash value life policy. If a fiduciary advisor is determining whether a client should keep that contract sold to him by his brother-in-law five years ago, she should be able to evaluate the actual life insurance costs in the policy based on state insurance filings and the in-force ledger,



# Sample VUL

## Product Profile

Product Rating: (3 1/2 stars out of 5 stars) ★★★★★  
 Product Type: VUL  
 Premium Type: Flexible  
 Min. Face Amount: \$100,000  
 Optimal Funding Strategy: Mixed

### Pricing Style:

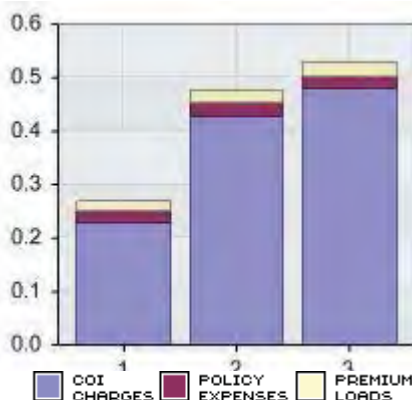
Policy pricing is a function of 3 factors: Cost of Insurance Charges (COIs), Expenses & Earnings. Product suitability is therefore categorized by the structure of and the underlying experience for these pricing components. (See The Pricing Advisor section below or at Veralytic.com for more information.)

	Max. Accum	Mixed	Min. Prem
Retail			
Institutional		■	
Experience-Rated			

Policy Under Evaluation		Avg for All Policies
38	# of Funds	56
28	# of Top Performers	40
0.87%	Avg Inv Mgmt Fee	0.89%

\* Source: Morningstar

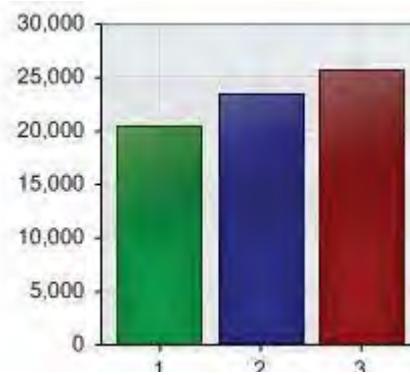
## Policy Expense Breakdown



1. Policy Under Evaluation
2. Institutionally Priced Policies
3. Retail Policies

Policy Expense Breakdown measures the present value cost per \$ of Death Benefit and the individual cost components, assuming identical funding amounts and funding patterns for a policy issued to a 60 year old male Non-Smoker Standard risk.

## Premium Comparison - Face Amt: \$1,000,000



1. Policy Under Evaluation
2. Institutional Pricing Benchmark
3. Benchmark for All Policies

Premium Comparison calculates the minimum level annual premium required over 40 years to endow the policy, assuming a 8% average net policy earnings rate and current expense assumptions for a policy issued to a 60 year old male Non-Smoker Standard risk.

## Cost of Insurance (COI) Charges

	Policy Under Evaluation	Institutional Pricing Benchmark	Benchmark for All Policies
Weighted-Average Annual COI	\$17,081	\$20,831	\$23,040

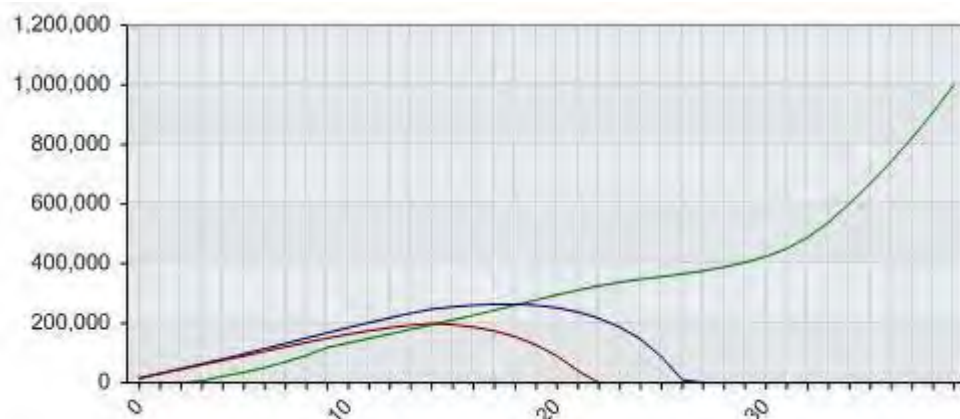
## Policy Expenses

	Policy Under Evaluation	Institutional Pricing Benchmark	Benchmark for All Policies
M&E Risk %	0.05	0.55	0.60
Other %	0.00	0.00	0.00
Total %	0.05	0.55	0.60
Loan Spread %	0.75	1.00	2.00
Fixed Charges Per Policy Yr	\$2,529	\$1,728	\$1,728

## Premium Loads

	Policy Under Evaluation	Institutional Pricing Benchmark	Benchmark for All Policies
State Tax %	2.35	2.35	2.35
Fed DAC Tax %	1.50	1.50	1.50
Carrier % Load(s)	0.00	0.00	0.00
Sales/Service % Load(s)	3.15	3.65	3.65
Total %	7.00	7.50	7.50

## Hypothetical Policy Cash Value Account Growth



## Planned Annual Premium: \$20,460

- Policy Under Evaluation
- Institutional Pricing Benchmark
- Benchmark for All Policies

The purpose of this graph is to show how different policy charges could effect policy value and death benefit. This graph is hypothetical and may not be used to predict or project actual policy performance or tax treatment.

Policy/Benchmark	Est Yr 1 Cash Value / Premium Ratio	Surrender Charge	Yrs Applied	Average Decrease %/Yr	Death Benefit @ Maturity or Lapse	Gross % Return	Net % Return	Net Net % Return
Policy Under Evaluation	0.00%	100.00%	9	11.1111%	\$1,000,880	8.87	8.00	7.95
Benchmark for Institutionally-Priced Policies	80.00%	0.00%	N/A	N/A	Lapse @ Y28	8.89	8.00	7.45
Benchmark for All Policies	0.00%	88.00%	11	8.0000%	Lapse @ Y23	8.89	8.00	7.40

borrowed from the policy free of income taxes so long as the policy stays in force. And owners are permitted to exchange one policy for another, or for an annuity contract, free of taxes, under the famous IRC Section 1035.

But, alas, despite these hard-won tax goodies the insurance industry seems to go out of its way to make it hard to love its products. Cash value life insurance has staked out the most complicated corner of the financial world, and it starts with the plethora of different ways the product can be structured: whole life, universal life, variable universal life, products with guaranteed death benefits that function like term policies, products with variable or fixed premiums.

Depending on what you're looking for, you might favor a policy that is designed to maximize the accumulation of (tax-free) cash values, which shaves the death benefit as low as it will go so there is less cost of insurance drag on the internal rate of return. Or—the opposite—a policy can maximize the death benefit in order to shepherd more money tax-free to heirs in a minimum premium plan by deliberately holding as little cash value as possible, and having most of the premium dollars paying the cost of insurance.

But underneath all this complexity is a relatively small number of modular parts: a term insurance policy combined with some kind of an investment account.

How do you analyze these

components? Start with expenses. Flagg notes that a policy's biggest expense is typically its cost of insurance—which, just like term insurance, is a function of the policyholder's age, health status and the face value (the death benefit amount). Beyond that are the state premium taxes, federal

at the minimum they are allowed to charge, and then they return money to their policyholders at the end of the year," says Flagg. "They call that a dividend," he adds, "and people think the dividend is earnings, and it's not; the dividend is a combination of a refund of overcharged expenses

*Cash value life insurance has staked out the most complicated corner of the financial world, and it starts with the different product structures.*

DAC taxes and charges for policy issue, administration, distribution and general operating expenses of the insurance carrier and/or the sales and servicing organization (aka commissions).

Then there's the rate of return on the cash account. For variable universal policies, this cash value is invested in the client's choice of mutual fund options, and you can look them up in Morningstar. Or it may be lumped together with all the other policyholders' cash values in the company's general account, as in a whole or universal life policy. To find this return, you have to go to the company's statutory financial statements.

Of course, a number of insurers who sell whole life policies re-complicated the situation by adding "dividends," which are not dividends at all. "Some policies set their expenses at the maximum they are allowed to charge, and they set their return

and a credit of excess interest."

*10,000 versions*

Reducing all these permutations of cash value life down to a few core underlying elements raises an interesting question about selecting life insurance products. Why can't somebody do more than what Veralytic does, and create a simple database that rates the different carriers and products, the way Morningstar does for mutual funds?

The answer is simple, even though the solution is not. "Every life insurance product, every single one, has upwards of 10,000 different prices," Flagg explains. "There is, of course, a different cost of insurance for every age [40 ages?], times two because the prices are different for each gender [80?], times three because the rate will be different for tobacco use or non-tobacco

use, or never tobacco use [240?]. Times five for the different health categories [1,200?]. Times four or six for what we call banding, which is basically different rates for different size policies [4,800 - 7,200?]. Times two to six for the different commission

cost of paying out a very high death benefit. Those same policies will be extremely sensitive to the size of the up-front commissions, which represent a front-end reduction in investment cash.

And, of course, that policy's investment returns will also

proprietary five-factor calculation model that Veralytic has patented:

1) The financial strength and claims paying ability of the company, which is a blending of the scores given to the issuer by different rating agencies like A.M. Best, Moody's, Standard & Poors and Fitch.

2) The internal costs inside the policy, either teased out of the policy illustration or the in-force ledger. "We are the only ones who do that; that's a subject of one of our patents," says Flagg.

3) The stability of those pricing representations. This can get complicated, but the simple issue here is that some insurance companies will issue policies with below-market COIs in order to get new business, and then later apply to the state for a higher cost of insurance rate, which means the policyholder, suddenly, is paying more than the illustration "promised." "A client's policy might have been bought at a time when the costs were in the range of best available rates of term," says Flagg, "but now you do the report and discover that the costs are 10% higher."

Why is this important? "With a mutual fund, if the prospectus says they are increasing costs on you, you can get out pretty easily," Flagg explains. "But with a life insurance policy, you could have pretty significant surrender charges, or you could have had a change in health where you can't go anywhere else. You're basically stuck with this policy."

4) The degree of access or restrictions on account values.

***One agent may charge 100% commission.  
Another may say, this is a big enough transaction  
that I will discount my commission by 50%.  
Another may discount by 75%.***

levels [9,600 - 43,200?], because most life insurance, even the commission products, can be discounted. One agent may say, I'm going to charge 100% commission; another may say, this is a big enough transaction that I will discount my commission by 50%. Another may say, I am going to discount by 75%.

"You go through all that math," says Flagg, "and there are 10,000 or more different prices for every single product. And in my experience, no carrier, whether it is no-load or load, is good at all the different pricings."

To make it even harder to compile a simple insurance database, sometimes certain cost and return elements matter a lot, and other times not so much. For instance, the accumulation policies that have lower face amounts won't be affected too much even if the cost of insurance is very high, because the policy isn't having to cover the actuarial

matter.

At the other end of the spectrum, with minimum premium plans, the cost of insurance will be a primary driver of efficiency, because the death benefit is maximized—and the company's investment experience is hardly a factor because there is so little cash value for it to impact.

Overlaying all of this is the unfortunate reality that the insurance industry seems to prefer obfuscation to disclosure. Think of the mutual fund industry pre-Morningstar, when nobody knew anybody's costs or track record.

Veralytic gets around these complexity hurdles by publishing reports on individual policies rather than spreadsheet-like rankings. If you're selecting a policy for a client, you might instruct your agent to select his or her three most competitive products and commission structures, and then run the policy illustrations through the

All things equal, a policy that provides greater access to the account value would be preferable to one that has large restrictions on getting your hands on the money.

5) The actual historical performance of invested assets underlying the cash values. For variable and variable universal life contracts, this would be a simple matter of pulling the performance information from Morningstar. For general accounts, Veralytic has access to the data provided in filings—and it also has a growing database with the actual performance that policyholders have experienced in contracts that have been submitted for analysis.

“On general account products like whole and universal life,” says Flagg, “our premise is: carriers that have a higher track record of performance on their general account are generally going to be able to credit more.”

The same five factors apply to existing policies; indeed, Flagg says that financial planners are more likely to have Veralytic analyze the in-force ledger of a policy that clients bought some years ago, than they are to propose buying a new cash value policy. When they’re evaluating a policy currently in force, their goal is to assess the break-even between paying a surrender charge now and doing an immediate 1035 exchange vs. overpaying internal expenses for some period of time in the future.

How do you access a report? “Subscribers would submit a request plus the requisite data—an in-force illustration [for policies

the client already owns] or an NAIC-compliant illustration, with include all pages including the cost disclosure pages [for policies under consideration to purchase],” says Flagg. “That gets uploaded to our system, and in about 30

Conseco, John Hancock, Lincoln, Phoenix and Transamerica. But Lincoln also tends to get high marks in the Veralytic reports for its guaranteed universal life products, which guarantee the death benefit so long as the

*Some insurance companies will issue policies with below-market COIs in order to get new business, and then later reapply for a higher rate on existing policyholders.*

seconds it runs it through all the algorithms and spits out a report on the other end and posts it to the user’s mailbox.”

#### *Return experience*

Aren’t some insurance carriers and some policies better, as a general rule, than others? Flagg says that no insurance firm is best, or worst, at all 10,000 permutations of a single contract, much less at all the different policy structures.

He also says that advisors should look at load alongside no-load policies, because a comprehensive review of all the costs and returns might turn up better numbers with the load policy—even with the commissions factored in—than the no-load one.

Some companies have undergone litigation for raising insurance and other costs after the policy illustrations were issued: Flagg pointed me to articles discussing suits against AXA,

premiums are paid.

Based on general account data pulled from various disclosures, Flagg was able to put together a list of companies that seem to do a better job on the investment side:

- American General Life: 5.92%
- Prudential Insurance: 5.79%
- USAA Life: 5.50%
- Guardian Life: 5.49%
- Columbus Life: 5.43%
- Minnesota Life: 5.31%

while at the other end of the spectrum, Accordia Life Insurance Co. is reporting a 2.47% rate of return on its general account.

If you’re concerned about the size of the commission, you can find it in the detailed expenses (page 12 of the sample report I received from Veralytic), and also in the calculation of “time-value-of-money weighted average annualized policy expenses and premium loads” (page 7 of the report I received).

What does Veralytic cost? For most financial planning





*"See if you can get them to raise their offer to \$24 in beads and trinkets before they discover that Manhattan real estate has totally collapsed."*

firms, the cost is \$200 a month for unlimited use. Many advisors rely on an outside insurance consultant to access reports on their behalf; John Ryan, of RISC Insurance in Greenwood Village, CO (<http://ryan-insurance.net/>) has become an effective analyst for NAPFA and FPA members.

Larger advisory firms can get discounted pricing, as can brokerage general agencies who want to provide this additional layer of analysis. The other Veralytic customers are trust

companies, which might be managing 1,000 life insurance trusts, who do annual due diligence on the underlying policies—and pay at an enterprise pricing model.

Flagg sees the day when his Veralytic service—like Morningstar's in the mutual fund arena—will bring about more routine transparency and perhaps even an evolving fiduciary mindset in the life insurance world.

"The investment business

has evolved, over the last 30 years, to a higher standard of care," he says. "But the life insurance industry still looks a lot like the investment business of the 1980s. Life insurance," he continues, "is the last corner of the investment markets where prudent investment principles have not been applied, and it is accordingly the most neglected asset on a financial planning client's balance sheet. Together, we and the fiduciary advisory community, could change that." ■





## Life Insurance Portfolio Performance Monitoring Report

Prepared for:

Valued Client  
123 Main Street  
Yourtown, FL

And:

Valued Client Irrevocable Trust dated 5/21/2009  
345 State Road 67  
Yourtown, FL

\*Securities may be offered through Kestra Investment Services, LLC (Kestra IS), member FINRA/SIPC. Investment Advisory Services may be offered through Kestra Advisory Services, LLC (Kestra AS), an affiliate of Kestra IS. Triangulum Financial Partners is a member of PartnersFinancial. Kestra IS and Kestra AS are not affiliated with Triangulum Financial Partners, PartnersFinancial, or any other entity listed herein.

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**Veralytic**

## Executive Summary

The purpose of this Life Insurance Portfolio Performance Monitoring Report (LIPPMR) for the Valued Client Life Insurance Portfolio is to confirm policy charges are in line with expectations, to measure performance of invested assets underlying policy cash values, and to generally assess the current status of the portfolio. This LIPPMR consists of this Executive Summary, a Summary of Portfolio Holdings, a Reconciliation of Portfolio Expenses and an Asset Allocation Summary.

### Portfolio Objective

The objective of the Valued Client Life Insurance Portfolio is for the purpose of closely-held stock redemption and estate tax financing, by using policies that secure the maximum amount of permanent life insurance death benefits from insurers with 1) high ratings for financial strength and claims-paying ability, and using products offering 2) a low cost structure, 3) stable pricing, 4) good cash value liquidity, and 5) superior historical performance of invested assets underlying policy cash values.

### Portfolio Construction

The portfolio consists of one (1) John Hancock Variable Universal Life (VUL) policy, with a face amount of \$8,740,000, and one (1) Brighthouse VUL policy, with a face amount of \$8,815,000, issued on the life of Valued Client, and with an overall rating of ★★★★★ (5-Stars out of a total 5-Stars, using Veralytic's patented Star Ratings<sup>1</sup>) based on 5-factors of product suitability as listed above. The owner and beneficiary of the policies is the Valued Family Irrevocable Insurance Trust, dated November 19, 2003.

### Initial Portfolio Status

The two policies in the portfolio were each funded via initial premium payments of \$875,000 per policy paid over two policy years in order to prevent violation of IRS Modified Endowment Contract (MEC) and Definition of Life Insurance (DOLI) premium limits and maintain the tax preferred status of the life insurance.

### Current Portfolio Status

The Valued Client life insurance portfolio is currently below original target funding objectives based on annual cash value targets required to endow policy cash values in amounts equal to the initial policy face amount at the policy maturity age. While policy investment performance has been 15.3% below originally targeted funding objectives (i.e., not a 15.3% loss, but instead a cumulative return on cash values that has averaged 6.7%, or 1.3% less than the target 8.0% net rate of return per year), there is no requirement that cash values must grow to endow for the full face amounts.

Your Risk Profile Questionnaire on file indicates a Moderate Risk profile; however your current allocations are indicative of a Moderate Aggressive risk tolerance. A Moderate Risk Profile is appropriate for policyholders whose primary objective is to grow cash values over the medium to long term so as to support higher policy death benefits and who are prepared to maintain policy cash values for 5 years or longer, and can tolerate some fluctuations in policy cash values in anticipation of possible higher returns, and where the investment strategy will cope with the effects of tax and inflation, and where cash values are invested predominantly in large-capitalization stocks and investment grade bonds, which are expected to produce returns ranging between -17.8% and 35.6% in 19 out of 20 years (i.e. with a 95% degree of certainty), and average 8.0% or more over time. (Source: Morningstar, Inc) Actual results may vary. Please contact us if you would like to discuss possible fund changes such that your allocations correlate to your Risk Profile.

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The above is derived from illustrations of hypothetical policy performance and related Veralytic Reports for the various products shown. As such, this is not complete without such corresponding illustrations and Veralytic Reports.

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Securities offered through Kestra Investment Services, LLC (Kestra IS), member FINRA/SIPC. Investment Advisory Services offered through Kestra Advisory Services, LLC (Kestra AS), an affiliate of Kestra IS. Triangulum Financial Partners is a member of PartnersFinancial. Kestra IS and Kestra AS are not affiliated with Triangulum Financial Partners or PartnersFinancial.



While the portfolio is currently below targeted objectives, performance has been consistent with the rate of return for relevant asset class benchmarks<sup>2</sup> over the same time period, and given the expected range of returns listed above, it is conceivable that the portfolio could catch up to originally targeted funding objectives within 1 year. Although policy earnings have been within the expected range of returns, investment performance can and will fluctuate over time.

### Portfolio Management Options

While the Valued Client life insurance portfolio is currently below original target funding objectives, the policies are not in danger of lapsing in the foreseeable future. The portfolio may thus be managed through the below portfolio management alternatives.

- 1) **Change Policy Funding:** To increase portfolio cash values needed to support originally projected death benefits, annual premium funding could be instituted in the amount of \$30,475 assuming the originally planned 8.0% net average rate of return. Alternatively, a lump sum premium of \$331,938 could be paid, assuming the originally planned 8.0% net average rate of return.
- 2) **Change Policy Benefits:** To reduce portfolio costs to levels that can be supported by currently planned premium payments, death benefits can be reduced by \$2,115,512 (from \$17,555,000 to \$15,439,488), assuming the originally planned 8.0% net average rate of return.
- 3) **Reallocate Cash Values:** To maintain growth of portfolio cash values necessary to support policy benefits, cash values may be re-allocated among the mutual-fund-like separate accounts to allocate more cash value to those asset classes that have produced historically higher returns, albeit with historically higher volatility in an effort to more accurately achieve a target rate of return of more than 10.0% gross.
- 4) **Re-rate Policy Pricing:** To reduce portfolio costs to levels that can be supported by current policy cash values and planned premiums, the current policies in the portfolio may be exchanged to a joint-life policy offering lower cost of insurance charges (COIs), lower fixed administration expenses (FAEs), and/or lower cash-value-based “wrap fees” (e.g., M&Es). These savings could be used to reduce policy funding, increase policy benefits, or reallocate cash values to reduce risk/volatility, as illustrated in Portfolio Management Techniques 1-3 listed above.
- 5) **Wait-and-See:** Because the current policy cash values are sufficient to support currently projected policy charges for at least the next 28 years, assuming the originally planned 8.0% net average rate of return from this point forward, a “wait and see” approach may be exercised.

***Please review these options and complete the enclosed Grantor Consent Form by selecting your preferred portfolio management option(s), sign and return to our office, to enable us to manage your portfolio accordingly.***

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<sup>1</sup> Veralytic Star Ratings indicate the relative appropriateness of a given product as measured against its peer group of products based on the five (5) factors of suitability as to: 1) financial strength and claims-paying ability ratings, 2) the relative competitiveness of cost of insurance charges, premium loads, fixed administration expenses and cash-value-based “wrap fees” as compared to peer group products, 3) pricing stability, 4) relative cash value liquidity as compared to peer group products, and 5) the historical performance of invested assets underlying policy cash values. Veralytic Star Ratings were invented by Barry D. Flagg (U.S. Patents #6,456,979 and #7,698,158), and are produced using generally accepted mathematical algorithms and a consistent and objective rules set, and like all ratings systems, rely on certain judgmental techniques, which are fully disclosed, and with which certain insurance professionals may disagree. Because any evaluation of a variable life product presented by any registered representative and pursuant to the purchase of such product presents the potential for a conflict of interest, it is important to understand the methodology behind any such evaluation and the relationship between the evaluator and the registered representative.

<sup>2</sup> See Asset Allocation Summary footnotes for detailed information regarding the various benchmarks used.

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## Summary of Account Holdings As of Policy Anniversaries

Company, Policy Number, Issue Date	Face Amount, Plan	Premium, Mode	Cash Accumulation Value <sup>1</sup>	Cash Surrender Value	Owner, Beneficiary
John Hancock Policy No. December 24, 2003	\$8,740,000 VUL	\$875,000 Modified Single Premium	\$1,163,579	\$1,163,579	Valued Family Irrevocable Insurance Trust
Selected Investment Allocation: 10% JHT Total Stock Market Index, 9% JHT 500 Index Trust, 9% JHT Mid Cap Stock, 5% JHT Mid Cap Index Trust, 5% JHT Mid Value, 5% JHT Small Cap Value Trust, 7% JHT Int'l Equity Index Trust, 10% JHT High Yield, 40% Fixed Account					
Brighthouse Policy No. June 20, 2003	\$8,815,000 VUL	\$875,000 Modified Single Premium	\$1,091,698	\$1,091,698	Valued Family Irrevocable Insurance Trust
Selected Investment Allocation: 4% Fidelity VIP Contrafund, 4% T. Rowe Price Large Cap Value, 5% Metlife Stock Index Class A, 4% American Funds IS Growth-Income 2, 6% Fidelity VIP Mid Cap Service, 4% Pioneer Mid-Cap Value VCT II, 4% Metropolitan Ser Russell 2000 Index A, 16% Metropolitan Ser MFS Total Return, 11% Met Invt Ser Tr MFS Research International B, 11% Western Asset Core Plus VIT, 6% Metropolitan Ser Black Rock Ultra Short Term Bond, 25% Fixed Account					
<b>Total</b>	<b>\$17,555,000</b>	<b>\$1,750,000</b>	<b>\$2,255,276</b>	<b>\$2,255,276</b>	

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<sup>1</sup> This material is provided as a general guide to the value of your portfolio and is for informational purposes only. These values represent an estimated assessment of the market environment of your account at a specific point in time and are based on data gathered from what we believe to be reliable sources. The summary of account values was obtained from the specific carrier as of the policy anniversaries. The prices listed may vary from actual liquidation value. Account values are not guaranteed by Kestra Investment Services, LLC as to accuracy, and do not purport to be complete, please contact your investment advisor directly for an exact account summary.

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## Reconciliation of Portfolio Expenses As of Policy Anniversaries

	Projected Values from Illustration of Hypothetical Policy Values	Actual Policy Values from Prior Year Annual Policy Statement
Beginning Portfolio Balance	\$2,538,377	\$2,062,593
Plus Premiums Paid	\$0	\$0
Premium Mode	Modified Single Premium	Modified Single Premium
Portfolio Expenses		
Cost of Insurance Charges (COIs)	(\$65,989)	(\$68,154)
Fixed Administration Fees (FAEs)	(\$108)	(\$108)
Cash-Value-Based "Wrap Fees" <sup>1</sup>	(\$11,412)	\$0
Premium Loads	\$0	\$0
Total Portfolio Expenses	(\$77,509)	(\$68,262)
Portfolio Earnings		
Gain/(Loss)	\$200,539	\$260,945
Rate of Return	8.0%	12.2%
Ending Portfolio Account Balance	\$2,661,407	\$2,255,276
Surrender Charge	\$0	\$0
Net Portfolio Surrender Value	\$2,661,407	\$2,255,276

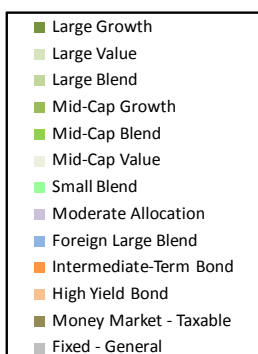
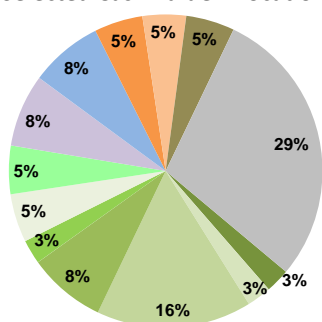
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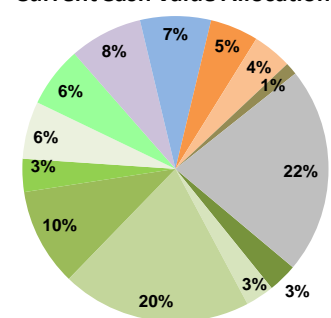
<sup>1</sup> MetLife does not disclose Cash-Value-Based "Wrap Fees" in their annual policy statements.

## Moderate Aggressive Risk Profile Asset Allocation Summary As of Policy Anniversaries

**Selected Cash Value Allocation**



**Current Cash Value Allocation**



Separate Account Name	Asset Class	Morningstar Rating™	Rate of Return on Individual Separate Accounts <sup>1</sup>	Rate of Return for Asset Class Indices <sup>2</sup>
Fidelity VIP Contrafund Service 2	Large Growth	★★★	19.1%	20.4%
T. Rowe Price Large Cap Value	Large Value	★★★★	17.1%	15.5%
Metropolitan Ser MetLife Stock Idx A	Large Blend	★★★★	17.4%	18.0%
Amer Funds IS Growth-Income 2	Large Blend	★★★	18.2%	18.0%
JHT Total Stock Market Index	Large Blend	★★★★	20.7%	21.7%
JHT 500 Index Trust	Large Blend	★★★★★	21.5%	21.7%
Fidelity VIP Mid Cap Service 2	Mid-Cap Growth	★★★	19.5%	17.1%
JHT Mid Cap Stock	Mid-Cap Growth	★★★	28.7%	25.3%
JHT Mid Cap Index	Mid-Cap Blend	★★★★★	15.9%	18.5%
Pioneer Mid Cap Value VCT II	Mid-Cap Value	★★	11.5%	13.4%
JHT Mid Value	Mid-Cap Value	★★★★★	15.2%	14.5%
Metropolitan Ser Russell 2000 Index A	Small Blend	★★★	23.5%	24.6%
JHT Small Cap Value	Small Blend	★★★★	3.8%	14.7%
Metropolitan Ser MFS Total Return F	Moderate Allocation	★★★	8.8%	11.0%
Met Invt Ser Tr MFS Research Intl B	Foreign Large Blend	★★★	18.3%	20.5%
JHT Intl Equity Index	Foreign Large Blend	★★★★	27.5%	27.2%
Western Asset Core Plus VIT	Intermediate-Term Bond	★★★	1.2%	(0.3%)
JHT High Yield	High Yield Bond	★★★	7.5%	7.5%
Metropolitan Ser BlkRk Utr-Sht Trm Bond	Money Market - Taxable	N/R	(0.2%)	0.1%
Fixed Account	Fixed - General	N/R	3.8%	3.8%
Fixed Account-JH	Fixed Account	N/R	4.0%	4.0%
Weighted Average Rate of Return for Portfolio			13.4%	13.9%

<sup>1</sup> The returns are reported for the time period most closely corresponding to the reporting period for this report. However, because performance for the various asset-class benchmarks is only reported as of the end of each month, the performance of the various separate account funds is also reported as of the end of the corresponding month for comparison purposes. In addition, because the returns shown above are intended to measure the performance of the individual separate account funds relative to their respective benchmarks, the returns for the separate account funds are not intended to reflect actual performance of the separate account funds for the reporting period for this report.

<sup>2</sup> Based on 66% equities as measured by performance of the, Russell 1000® Growth, Russell 1000® Value, Russell 1000®, Russell Mid Cap Growth, Russell Mid Cap Value, Russell 2000®, Morningstar Moderately Target Risk, and MSCI AC World ex US indices, 10% bonds as measured by performance of the BBgBarc US Agg Bond and ICE BofAML US HY Master II indices, and 24% Money Market & Fixed Income assets.

The **Russell 1000® Growth** tracks the companies within the Russell 1000 with higher price-to-book ratios and higher forecasted growth values.

The **Russell 1000® Value Index** tracks the companies within the Russell 1000 with lower price-to-book ratios and lower forecasted growth values.

The **Russell 1000® Index** consists of the 1,000 largest companies within the Russell 3000 Index, which represents approximately 98% of the investable US equity market.

The **Russell 2000® Index** consists of the 2,000 smallest companies in the Russell 3000® Index.

The **Russell MidCap® Index** measures the performance of the 800 smallest companies in the Russell 1000 Index, which represents approximately 25% of the total market capitalization of the Russell 1000 Index.

The **Russell Midcap® Growth Index** tracks the companies within the Russell Midcap Index with higher price-to-book ratios and higher forecasted growth values.

The **Russell Mid Cap® Value** tracks the companies within the Russell Midcap Index having lower price-to-book ratios and lower forecasted growth values.

The **Morningstar Mod Tgt Risk Index** represents a portfolio of global equities, bonds and traditional inflation hedges such as commodities and TIPS. This portfolio is held in a static allocation appropriate for US investors who seek average exposure to equity market risk and returns.

The **MSCI AC World ex USA** is a free float-adjusted market capitalization index that is designed to measure equity performance in the global developed and emerging markets, and is comprised of 48 developing and emerging market country indices.

The **BBgBarc US Agg Bond** is composed of the BarCap Government/Credit Index, the Mortgage-Backed Securities Index, and the Asset-Backed Securities Index. The returns we publish for the index are total returns, which include daily reinvestment of dividends.

The **ICE BofAML US HY Master II Index** tracks the performance of below investment grade US dollar-denominated corporate bonds publicly issued in the US domestic market. Yankee bonds are included in the Index provided the issuer is domiciled in a country having an investment grade foreign currency long-term debt rating. 14 4a issues are not included in the index until they are exchanged for registered securities. Qualifying bonds must have at least one year remaining term to maturity, a fixed coupon schedule and a minimum amount outstanding of USD 100 million.

The **BBgBarc US Government/Credit 1-5 Year Index** represents a combination of the Government and Corporate Bond indices for bonds with maturities between one and five years. The returns published for the index are total returns, which include reinvestment of dividends.



## Grantor Election Form

[Policy\_Number]

Due to recent advances in and new tools for managing trust-owned life insurance, we are now able to measure internal policy costs, and are pleased to inform you that lower costs may be available. To participate in the underwriting process to re-qualify for the same health-risk class or better with the insurer offering best-available rates and terms, please mark an "X" in the box(es) below to indicate your Grantor Intent for any cost savings, and sign the Grantor Consent below.

### Grantor Intent

(Check all that apply.)

- Decrease Planned Premiums to as little as \$0 (i.e., \$8,300 savings)** a year while maintaining the current \$400,000 death benefit to age 95, similarly acceptable ratings for financial strength and claims-paying ability, and the same 5.00% target rate of return, or
- Increase Death Benefits to as much as \$550,000 (i.e., +\$150,000)** while continuing the current \$8,300 planned annual premium, and maintaining similarly acceptable ratings for financial strength and claims-paying ability, the same 5.00% target rate of return, and the same age 95 coverage duration, or
- Extend the Coverage Duration beyond Age 95** while continuing the current \$8,300 planned annual premium, and maintaining the current \$400,000 death benefit, similar financial strength and claims-paying ability ratings, and the same 5.00% target rate of return, or
- Decrease the risk of a "Premium Call"/increase** in the event the 5.00% target rate of return is not sustained over the life of the policy, while maintaining the current \$400,000 death benefit to age 95 and similarly acceptable ratings for financial strength and claims-paying ability, or
- Pay Trust Administration Fees** for the foreseeable future while continuing the current \$8,300 planned annual premium, and maintaining the current \$400,000 death benefit to age 95, similar financial strength and claims-paying ability ratings, and the same 5.00% target rate of return.

### Grantor Consent

I understand that qualifying for lower costs requires an underwriting process to include a health profile questionnaire, a HIPAA Authorization to release medical records, financial statements (if necessary), and/or a medical exam, and hereby consent to participate in this underwriting process and provide this information to [Sub-Advisor\_name] as sub-advisor to the trust.

\_\_\_\_\_  
Grantor

\_\_\_\_\_  
Date

### Declination

I decline to participate in this process to qualify for lower costs, and understand that any a) new product recommendations by a life insurance agent of my choosing must be supported by independent verification cost savings as they relate to industry benchmarks for best-available rates and terms, and that b) comparisons of hypothetical policy values now considered "misleading", "fundamentally inappropriate", and unreliable by financial, insurance, and banking industry authorities cannot be accepted as support for such product recommendations.

\_\_\_\_\_  
Grantor

\_\_\_\_\_  
Date







## Should My Client Finance Life Insurance Premiums?

Rebecca Ryan CFP®  
Head of Private Bank Life Insurance Lending  
BNY Mellon

With contributions from Bryan Schick, CPA, and special thank you to Barry Flagg CFP®, CLU, ChFC, GFS®

An insurance sale should never be dependent on the client's ability to finance the transaction. If you encounter that situation, my advice would be to walk away ... or better yet, *run away!*

The simplicity of premium finance is that it is merely an alternative to paying for the policy. There should be no magic— no WOW factor. Rather, it should be the natural outcome of working with an interdisciplinary team of professionals on how to best optimize a client's balance sheet. So many conversations need be had prior to discussing how to pay for the insurance.

Conversations like:

- 1) What tools have been used to freeze/gift/compress the taxable estate?
- 2) Is there still a need for insurance?
- 3) What is the need – and what does it need to cover? The consideration for financing has a direct correlation to the intended purpose, or use, of the insurance coverage. Having to provide a family with shelter or education should not be financed. Being able to preserve illiquid assets to preserve and pass family wealth or potentially compress a taxable estate are situations that may be ripe for third-party financing.
- 4) How was the insurance need quantified?
- 5) Does it make sense?
- 6) Which product makes the most sense for this client profile (too often an ability to build cash value with subsidizing riders makes financing look deceptively attractive. Understanding your client and choosing the appropriate product are the foundation for success whether financing is utilized or not
- 7) Now we ask: What is the **most efficient** way to pay for the policy? Start with:
  - a. What are the costs? The costs are the internal expenses including mortality, administrative, policy servicing etc. In a universal life policy that has an accumulation component, the premium is the discounted cash flows the client must pay over a defined period of time that, when added to the interest/earnings on the policy's accumulated value, should keep the policy in force though a predetermined age. The alternative is to pay out of pocket year over year through life expectancy. Understanding the costs helps clients better understand the nature of the premium requirements. Once clients understand the nature of the amounts the client will pay out of pocket year over year through life expectancy (and for a healthy affluent individual who has access to good medical care it is often beyond actuarial life expectancy). Another question to consider is whether the client should use annual exclusions or gifting?
  - b. What does it cost to borrow in lieu of paying outright and how will the loan be repaid? (Morbidly, early death is an easy repayment solution to model but not as easy to administer.) Considerations include:
    - i. Interest cost
    - ii. Collateral need upfront and over the lifecycle of the strategy
    - iii. Opportunity cost of pledged collateral or cash payments
    - iv. Does the product chosen have the ability to accumulate enough in the savings component to take advantage of basis removal or a policy loan to repay the third-party lender? OR  
Is there an alternative strategy that can be used to repay the loan?
    - v. How will it be monitored (and is the team capable of monitoring)?

Other panelists have provided extensive information on products and uses but premium finance provides more than just what is the best way to pay – there are tax and interest arbitrage opportunities that make just paying with other

people's money attractive.

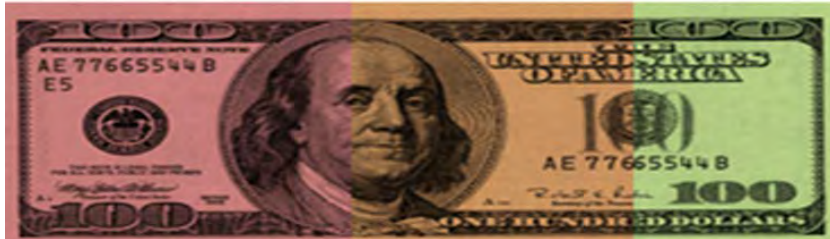
When a client pays life insurance premiums using earned income to pay for a life insurance premium that is owned by an Irrevocable Life Insurance Trust (ILIT)—in the most extreme case—he or she turns each dollar of earned income into 0.30¢ of purchasing power for a product that has premium tax, mortality costs and administrative expenses.

(Marginal rates applied are for illustrative purposes only)

(Income Tax: 40¢)

(Gift Tax: 30¢)

(Remainder Purchasing Power: 30¢)



**Benefits of Premium Finance**

**Benefit 1:** If the funds can be borrowed by the ILIT then 100% of the loan proceeds go to the premium. Borrowing can save up to 70¢ on the dollar in tax savings on the front end.

**Benefit 2:** The “investment component of the policy” (cash surrender accumulation which is driven by product type) grows tax-deferred as long as it meets the requirements for insurance under IRC Section 7702 and 7702A.

**Benefit 3:** Under IRC Section 72(e)(5)(C), distributions from that cash value are treated first as a return of principal (the “investment in the contract”). Gains are taxed only after the cost basis has been recovered. (This is not true for Modified Endowment Contracts which do not meet the requirements of insurance under IRC section 7702A.)

**Benefit 4:** Under IRC Section 101(a), “gross income does not include amounts received under a life insurance contract, if such amounts are paid by reason of the death of the insured.”

The optimal financing strategy maximizes the benefits of life insurance by acquiring the policy on a tax-efficient basis, growing the investment in the policy on a tax-deferred basis, removing basis or taking a policy loan (tax-free distributions) to repay the lender while keeping enough tax-deferred gain in the policy to support the policy through life expectancy; and then, ultimately passing the death benefit outside of the taxable estate and income tax-free to the beneficiaries. A finance strategy may only take advantage of one of the benefits, or may combine all of them. Ultimately, it should be used to optimize a client’s balance sheet and cash flow – not to sell more insurance.

**Risks of Premium Finance**

Life Insurance is a risk transfer tool. By adding leverage, one is fundamentally adding risk. What should a client be aware of and how can the professional team help?

Risk	Comment
Interest Rate	While there is no sure-fire way to predict FED activity, clients can manage “spread” risk through their relationship with the Lender and all-in risk with a swap or a cap. Initial modeling with high and low rates should be reviewed.
Carrier Efficacy	Carrier’s performance is outside of the client’s control. However Carriers are required to file financial statements quarterly and financial strength can be monitored through these filings. Most Lenders have minimum financial strength rating requirements. One option is to use multiple carriers.
Lender Longevity	There is a history of Lenders entering and exiting the space. Choosing the right Lender is critical. A Lender who exits the premium financing space before the premium loan is repaid can increase financing costs at an inopportune time

	and/or undo many, if not all, of the expected benefits of financing.
Policy Type	Every policy type has specific characteristics and riders, and policies of the same type vary by carrier (think caps and participation rates on EIUL Products). It is critical to understand the impact of the policy type on the financing.
Funding Pattern	Most premium finance strategies are designed to maximum-fund up to the MEC limit over a short period of time. This is to allow a larger base for tax deferred growth and effectively lowers the net amount at risk.
Policy Performance	Illustrations are hypothetical projections and linear which therefore do not reflect the inevitable variation in policy performance over time. It is critical to monitor actual performance against initial projected performance with attribution and the client must understand that there will need to be corrective steps along the way. As long as this is monitored at least annually, the corrective action will be clear. Trying to fix a strategy that has varied significantly from plan can be painful and is sometimes irreparable. Reducing face value of insurance may create a Modified Endowment Contract under <u>Internal Revenue Code 7702(f)(7) and Internal Revenue Code 7702(f)(7)(B)</u> and may not be an option in the first 10 years.
Collateral Need –	<p>Sales tools will typically show collateral need over the lifecycle under an illustrated performing scenario. It is critical to understand the collateral need over the lifecycle of the transactions. Most typically it is a bell curve, just because the client has the liquidity to meet the collateral need day one does not mean he or she is prepared to meet it over the lifecycle of transaction. Understanding collateral under a guaranteed scenario is also important for a few reasons:</p> <ol style="list-style-type: none"> <li>1) It provides insight into the worst policy performance possible.</li> <li>2) It provides a guidepost for discussion on downside and reaffirms that this transaction does in fact have risk.</li> <li>3) It shows the client where to stop the transaction and not to throw good money after bad.</li> </ol>
Collateral Types	Most Lenders prefer marketable securities as collateral. Some will take assets held away, real estate, standby letters of credit and potentially private equity or hedge funds. This is Lender specific. In general, the loan spread will most likely increase if illiquid collateral is pledged.
Advance Rates	Models often show cash value and collateral calculations that do not take into account the bank advance rate. It is atypical for a lender to advance 100% on any asset held as collateral. Actual collateral requirements may be significantly larger than what is shown in sales materials.
Interest Payments	Is it better to pay interest out of pocket or capitalize into the loan? This is not a black and white question. It is dependent on client and risk profile as well as strategy. Under some models the client may pay more in interest than if they just paid for the premium outright.
Cash Contribution	Often strategies have the client making a cash contribution into the strategy. Whether it is through the use of exemption, gifting or annual exclusion, any equity paid into the strategy puts less strain on policy performance and reduces the risk inherent in leverage.
Exit Planning	Morbidly, early death is an easy exit to model, but is that a good selling point to clients? If so, then great. If not, then an exit must be contemplated at design, either through distributions or policy loans, or another estate planning tool. Setting client expectations to maintain a loan outstanding until death and payoff the loan at death as the only exit strategy, and have the needed death benefit to meet the problem identified, is just not realistic in an ever-changing world.

Variable Life	Under the Securities Exchange Act of 1933 and Investment Advisors Act of 1940, variable life insurance is considered an investment product and therefor is subject to Federal Reserve Board Regulation U. The advance rate under Regulation U is limited to 50% of the cash surrender value. As such many Lenders will not take a variable contract as collateral and many carriers will not allow variable products to be financed.
Modified Endowment Contracts	Policies that meet the requirements for Insurance Contracts under <u>IRC Section 7702</u> but not 7702(A) are MEC policies and are taxed differently than non-MEC policies. As such, internal policy earnings in a collaterally-assigned MEC policy are taxable each year such earnings exceed basis whether or not there is a distribution.
Source Materials	Ask for source materials, specifically the detailed policy accounting pages of the illustration showing year-by-year disclosure of all policy expenses and policy interest/earnings assumptions. Insurance carriers disclose significant information in the full illustration that will not be captured in a summary model. The source information is critical to understanding actual transaction costs that will have to be covered by the client if policy earnings fall short of expectations, the guarantees, riders, caps, participation rates, and illustration interest/earnings assumptions. Sometimes the final policy and the illustration sold are not identical.

### Sample Illustrations

The following examples all solve for a death benefit, net of loan repayment of \$15,000,000. Each example provides guaranteed, alternative and illustrated returns. All assume male preferred smoker age 57. The examples are from three different carriers, all represent that carriers Indexed Universal Life offering and solve for the same solution. The loan interest rate is based on the forward looking LIBOR curve, as found on Reuters and adds 150 basis point spread to the LIBOR base. Return assumptions are based on the National Association of Insurance Commissioners (NAIC) Actuarial Guideline XLIX (AG49) which became effective September 1, 2015 as a guideline to increase the consumer's understanding of the potential variability in IUL product crediting rates.

As detailed in related papers, illustration returns are based on a matrix of option returns using caps, floors and participations rates. In any given year, the carrier has the sole discretion to modify the cap, floor and participation rate. Prior to September 1, 2015, carriers were using selective lookback periods or customized options strategies to improve return optics. AG 49 was designed to level set how a carrier can illustrate based on that carrier's index performance with the maximum illustrated return being that carrier's one-year, point-to-point index return in the S&P 500® ex-dividends with 100% participation, no spread and no cap. As you will note, even with the level set, carriers can legally illustrate at different rates based on company specific performance.

### Carrier 1

Assumptions																
LIBOR Spread	1.50%															
CSV Advance	95.00%															
Insured Carrier	57 Male example 1															
Policy Type	IUL															
Age	Year	Loan Draw	Interest Rate	Cumulative Interest Out of Pocket	Loan Repayment	Year End Loan Balance	CSV @ 95%	Collateral Shortfall	Net Cash to Trust	CSV @ 95%	Collateral Shortfall	Net Cash to Trust	CSV @ 95%	Collateral Shortfall	Net Cash to Trust	
57	1	\$ 1,078,103	3.62%	\$ 39,538	\$ -	\$ 1,078,103	\$ -	\$ (1,078,103)	\$ 16,090,365	\$ -	\$ (1,078,103)	\$ 16,179,301	\$ -	\$ (1,078,103)	\$ 16,217,075	
58	2	\$ 1,078,103	4.11%	\$ 129,412	\$ -	\$ 2,156,206	\$ 507,754	\$ (1,648,452)	\$ 15,670,272	\$ 697,443	\$ (1,458,763)	\$ 15,869,945	\$ 804,307	\$ (1,351,899)	\$ 15,982,433	
59	3	\$ 1,078,103	4.27%	\$ 269,474	\$ -	\$ 3,234,309	\$ 1,137,176	\$ (2,097,133)	\$ 15,238,218	\$ 1,453,069	\$ (1,781,240)	\$ 15,570,737	\$ 1,669,068	\$ (1,565,241)	\$ 15,798,105	
60	4	\$ 1,078,103	4.30%	\$ 457,437	\$ -	\$ 4,312,412	\$ 1,768,530	\$ (2,543,882)	\$ 15,088,699	\$ 2,231,871	\$ (2,080,541)	\$ 15,279,426	\$ 2,598,385	\$ (1,714,027)	\$ 15,665,230	
61	5	\$ 1,078,103	4.30%	\$ 692,344	\$ -	\$ 5,390,515	\$ 2,367,130	\$ (3,023,385)	\$ 14,327,201	\$ 2,999,331	\$ (2,391,185)	\$ 14,992,675	\$ 3,561,075	\$ (1,829,440)	\$ 15,583,985	
62	6	\$ 1,078,103	4.34%	\$ 977,208	\$ -	\$ 6,468,618	\$ 2,970,030	\$ (3,498,588)	\$ 13,850,729	\$ 3,812,968	\$ (2,655,650)	\$ 14,738,033	\$ 4,621,768	\$ (1,846,850)	\$ 15,589,401	
63	7	\$ 1,078,103	4.40%	\$ 1,313,580	\$ -	\$ 7,546,721	\$ 3,582,526	\$ (3,964,195)	\$ 13,351,359	\$ 4,685,745	\$ (2,860,976)	\$ 14,512,642	\$ 5,797,107	\$ (1,749,614)	\$ 15,682,497	
64	8	\$ 1,078,103	4.42%	\$ 1,699,939	\$ -	\$ 8,624,824	\$ 4,187,738	\$ (4,437,086)	\$ 12,827,821	\$ 5,602,970	\$ (3,021,854)	\$ 14,317,539	\$ 7,078,157	\$ (1,546,667)	\$ 15,870,368	
65	9	\$ 1,078,103	4.46%	\$ 2,139,105	\$ -	\$ 9,702,927	\$ 4,768,620	\$ (4,934,307)	\$ 12,278,673	\$ 6,549,992	\$ (3,152,935)	\$ 14,153,801	\$ 8,456,529	\$ (1,246,398)	\$ 16,160,682	
66	10	\$ 1,078,103	4.51%	\$ 2,631,876	\$ -	\$ 10,781,030	\$ 5,324,907	\$ (5,456,123)	\$ 11,703,635	\$ 7,527,868	\$ (3,253,162)	\$ 14,022,542	\$ 9,940,097	\$ (840,933)	\$ 16,561,730	
67	11		4.54%	\$ 3,128,549	\$ -	\$ 10,781,030	\$ 4,998,849	\$ (5,782,181)	\$ 11,294,416	\$ 7,573,016	\$ (3,208,014)	\$ 14,004,066	\$ 10,531,403	\$ (249,627)	\$ 17,118,157	
68	12		4.55%	\$ 3,626,133	\$ -	\$ 10,781,030	\$ 4,659,275	\$ (6,121,755)	\$ 10,854,470	\$ 7,613,855	\$ (3,167,175)	\$ 13,964,554	\$ 11,161,337		\$ 17,698,746	
69	13		4.53%	\$ 4,121,623	\$ -	\$ 10,781,030	\$ 4,289,897	\$ (6,491,133)	\$ 10,383,151	\$ 7,642,600	\$ (3,138,430)	\$ 13,912,312	\$ 11,824,891		\$ 18,314,724	
70	14		4.54%	\$ 4,617,625	\$ -	\$ 10,781,030	\$ 3,885,101	\$ (6,895,929)	\$ 9,874,550	\$ 7,646,354	\$ (3,134,676)	\$ 13,833,764	\$ 12,512,023		\$ 18,955,521	
71	15		4.54%	\$ 5,113,842	\$ -	\$ 10,781,030	\$ 3,425,000	\$ (7,356,030)	\$ 9,324,233	\$ 7,605,776	\$ (3,175,254)	\$ 13,725,050	\$ 13,206,128		\$ 19,620,157	
72	16		4.47%	\$ 5,602,501	\$ -	\$ 10,781,030	\$ 2,934,196	\$ (7,846,834)	\$ 8,807,597	\$ 7,549,971	\$ (3,231,059)	\$ 13,666,308	\$ 13,941,030		\$ 20,393,738	
73	17		4.45%	\$ 6,089,340	\$ -	\$ 10,781,030	\$ 2,388,529	\$ (8,392,501)	\$ 8,233,211	\$ 7,452,751	\$ (3,328,279)	\$ 13,563,971	\$ 14,695,053		\$ 21,187,447	
74	18		4.43%	\$ 6,573,856	\$ -	\$ 10,781,030	\$ 1,785,037	\$ (8,995,993)	\$ 7,597,956	\$ 7,308,204	\$ (3,472,826)	\$ 13,411,816	\$ 15,465,212		\$ 21,998,141	
75	19		4.41%	\$ 7,055,542	\$ -	\$ 10,781,030	\$ 1,117,276	\$ (9,665,754)	\$ 6,895,050	\$ 7,110,018	\$ (3,671,012)	\$ 13,203,199	\$ 16,248,083		\$ 22,822,215	
76	20		4.38%	\$ 7,533,920	\$ (10,781,029)							\$ 5,970,013			\$ 22,784,224	
77	21														\$ 15,000,000	

## Carrier 2

Assumptions														
LIBOR Spread	1.50%													
Guaranteed Crediting Rate:	0.00%													
Illustrated Crediting Rate:	6.21%													
CSV Advance	95.00%													
Insured	57 Male													
Carrier	example 1													
Policy Type	IUL													

Age	Year	Loan Draw	Interest Rate	Cumulative Interest Out of Pocket	Loan Repayment	Year End Loan Balance	CSV @ 95%	Collateral Shortfall	Net Cash to Trust	CSV @ 95%	Collateral Shortfall	Net Cash to Trust	CSV @ 95%	Collateral Shortfall	Net Cash to Trust
57	1	\$ 1,169,586	3.62%	\$ 42,893	\$ -	\$ 1,169,586	\$ 125,122	\$ (1,044,464)	\$ 16,069,625	\$ 279,935	\$ (889,651)	\$ 16,232,586	\$ 312,038	\$ (857,548)	\$ 16,266,379
58	2	\$ 1,169,586	4.11%	\$ 140,394	\$ -	\$ 2,339,172	\$ 835,865	\$ (1,503,307)	\$ 15,629,450	\$ 1,173,527	\$ (1,165,645)	\$ 15,984,883	\$ 1,269,104	\$ (1,070,068)	\$ 16,085,490
59	3	\$ 1,169,586	4.27%	\$ 292,341	\$ -	\$ 3,508,758	\$ 1,525,191	\$ (1,983,567)	\$ 15,166,729	\$ 2,090,279	\$ (1,418,479)	\$ 15,761,559	\$ 2,283,525	\$ (1,225,234)	\$ 15,964,975
60	4	\$ 1,169,586	4.30%	\$ 496,253	\$ -	\$ 4,678,344	\$ 2,284,463	\$ (2,393,881)	\$ 14,691,742	\$ 3,086,777	\$ (1,591,567)	\$ 15,536,283	\$ 3,414,930	\$ (1,263,414)	\$ 15,881,708
61	5	\$ 1,169,586	4.30%	\$ 751,094	\$ -	\$ 5,847,930	\$ 2,959,736	\$ (2,888,194)	\$ 14,189,243	\$ 4,046,195	\$ (1,801,735)	\$ 15,332,884	\$ 4,549,542	\$ (1,298,388)	\$ 15,862,722
62	6	\$ 1,169,586	4.34%	\$ 1,060,130	\$ -	\$ 7,017,516	\$ 3,604,722	\$ (3,412,794)	\$ 13,655,361	\$ 5,029,192	\$ (1,988,324)	\$ 15,154,803	\$ 5,751,800	\$ (1,265,716)	\$ 15,915,443
63	7	\$ 1,169,586	4.40%	\$ 1,425,044	\$ -	\$ 8,187,102	\$ 4,217,745	\$ (3,969,357)	\$ 13,087,335	\$ 6,038,701	\$ (2,148,401)	\$ 15,004,130	\$ 7,028,800	\$ (1,158,302)	\$ 16,046,340
64	8	\$ 1,169,586	4.42%	\$ 1,844,188	\$ -	\$ 9,356,688	\$ 4,791,323	\$ (4,565,365)	\$ 12,483,535	\$ 7,071,184	\$ (2,285,504)	\$ 14,883,388	\$ 8,381,555	\$ (975,133)	\$ 16,262,726
65	9	\$ 1,169,586	4.46%	\$ 2,320,620	\$ -	\$ 10,526,274	\$ 5,361,259	\$ (5,165,016)	\$ 11,842,042	\$ 8,165,765	\$ (2,360,509)	\$ 14,794,154	\$ 9,854,147	\$ (672,127)	\$ 16,571,398
66	10	\$ 1,169,586	4.51%	\$ 2,855,205	\$ -	\$ 11,695,860	\$ 5,864,807	\$ (5,831,053)	\$ 11,161,902	\$ 9,260,207	\$ (2,435,653)	\$ 14,736,007	\$ 11,389,705	\$ (306,155)	\$ 16,977,584
67	11		4.54%	\$ 3,394,023	\$ -	\$ 11,695,860	\$ 5,283,203	\$ (6,412,657)	\$ 10,512,207	\$ 9,329,615	\$ (2,366,245)	\$ 14,771,588	\$ 11,901,598		\$ 17,478,938
68	12		4.55%	\$ 3,933,831	\$ -	\$ 11,695,860	\$ 4,646,239	\$ (7,049,621)	\$ 9,809,922	\$ 9,371,670	\$ (2,324,190)	\$ 14,784,060	\$ 12,420,426		\$ 17,993,277
69	13		4.53%	\$ 4,471,365	\$ -	\$ 11,695,860	\$ 3,962,409	\$ (7,733,451)	\$ 9,053,182	\$ 9,393,044	\$ (2,302,816)	\$ 14,769,640	\$ 12,954,766		\$ 18,518,821
70	14		4.54%	\$ 5,009,456	\$ -	\$ 11,695,860	\$ 3,220,600	\$ (8,475,260)	\$ 8,234,849	\$ 9,387,567	\$ (2,308,293)	\$ 14,726,394	\$ 13,500,411		\$ 19,055,704
71	15		4.54%	\$ 5,547,780	\$ -	\$ 11,695,860	\$ 2,414,796	\$ (9,281,065)	\$ 7,349,153	\$ 9,348,843	\$ (2,347,017)	\$ 14,648,150	\$ 14,052,977		\$ 19,599,870
72	16		4.47%	\$ 6,077,904	\$ -	\$ 11,695,860	\$ 1,687,548	\$ (10,008,312)	\$ 6,580,506	\$ 9,425,689	\$ (2,270,171)	\$ 14,725,918	\$ 14,765,289		\$ 20,346,549
73	17		4.45%	\$ 6,606,055	\$ -	\$ 11,695,860	\$ 875,182	\$ (10,820,678)	\$ 5,725,384	\$ 9,462,933	\$ (2,232,927)	\$ 14,765,122	\$ 15,487,940		\$ 21,107,235
74	18		4.43%	\$ 7,131,684	\$ -	\$ 11,695,860				\$ 9,458,027	\$ (2,237,833)	\$ 14,759,958	\$ 16,221,015		\$ 21,878,893
75	19		4.41%	\$ 7,654,243	\$ -	\$ 11,695,860				\$ 9,403,473	\$ (2,292,387)	\$ 14,702,533	\$ 16,959,667		\$ 22,656,421
76	20		4.38%	\$ 8,173,215	\$ (11,695,860)	\$ -							\$ 6,194,485		\$ 22,656,421
77	21														\$ 15,000,000

## Carrier 3

Assumptions														
LIBOR Spread	1.50%													
CSV Advance	95.00%													
Insured	57 Male													
Carrier	example 1													
Policy Type	IUL													

Age	Year	Loan Draw	Interest Rate	Cumulative Interest Out of Pocket	Loan Repayment	Year End Loan Balance	CSV @ 95%	Collateral Shortfall	Net Cash to Trust	CSV @ 95%	Collateral Shortfall	Net Cash to Trust	CSV @ 95%	Collateral Shortfall	Net Cash to Trust
57	1	\$ 1,100,000	3.62%	\$ 40,341	\$ -	\$ 1,100,000	\$ 20,589	\$ (1,079,411)	\$ 14,739,355	\$ 112,422	\$ (987,578)	\$ 14,836,020	\$ 128,889	\$ (971,111)	\$ 14,853,354
58	2	\$ 1,100,000	4.11%	\$ 132,041	\$ -	\$ 2,200,000	\$ 751,774	\$ (1,448,226)	\$ 14,371,850	\$ 966,712	\$ (1,233,288)	\$ 14,598,101	\$ 1,015,791	\$ (1,184,209)	\$ 14,649,762
59	3	\$ 1,100,000	4.27%	\$ 274,948	\$ -	\$ 3,300,000	\$ 1,469,928	\$ (1,830,072)	\$ 13,995,164	\$ 1,838,934	\$ (1,461,066)	\$ 14,383,591	\$ 1,938,184	\$ (1,361,816)	\$ 14,488,055
60	4	\$ 1,100,000	4.30%	\$ 466,728	\$ -	\$ 4,400,000	\$ 2,175,966	\$ (2,224,034)	\$ 13,606,760	\$ 2,745,045	\$ (1,654,955)	\$ 14,205,789	\$ 2,913,640	\$ (1,486,360)	\$ 14,383,258
61	5	\$ 1,100,000	4.30%	\$ 706,406	\$ -	\$ 5,500,000	\$ 2,866,928	\$ (2,633,072)	\$ 13,203,570	\$ 3,681,361	\$ (1,818,639)	\$ 14,060,869	\$ 3,940,251	\$ (1,559,749)	\$ 14,333,384
62	6	\$ 1,100,000	4.34%	\$ 997,056	\$ -	\$ 6,600,000	\$ 3,562,589	\$ (3,037,411)	\$ 12,782,599	\$ 4,657,711	\$ (1,942,289)	\$ 13,935,360	\$ 5,029,574	\$ (1,570,426)	\$ 14,326,793
63	7	\$ 1,100,000	4.40%	\$ 1,340,259	\$ -	\$ 7,700,000	\$ 4,238,713	\$ (3,461,287)	\$ 12,341,063	\$ 5,655,247	\$ (2,044,753)	\$ 13,832,152	\$ 6,164,508	\$ (1,535,492)	\$ 14,368,216
64	8	\$ 1,100,000	4.42%	\$ 1,734,466	\$ -	\$ 8,800,000	\$ 4,892,127	\$ (3,907,873)	\$ 11,875,621	\$ 6,781,751	\$ (2,018,249)	\$ 13,864,699	\$ 7,455,809	\$ (1,344,191)	\$ 14,574,234
65	9	\$ 1,100,000	4.46%	\$ 2,182,551	\$ -	\$ 9,900,000	\$ 5,519,703	\$ (4,380,297)	\$ 11,382,983	\$ 7,934,033	\$ (1,965,967)	\$ 13,924,382	\$ 8,803,320	\$ (1,096,680)	\$ 14,839,422
66	10	\$ 1,100,000	4.51%	\$ 2,685,331	\$ -	\$ 11,000,000	\$ 6,118,953	\$ (4,881,047)	\$ 10,860,526	\$ 9,119,795	\$ (1,880,205)	\$ 14,019,307	\$ 10,217,150	\$ (782,850)	\$ 15,174,418
67	11		4.54%	\$ 3,192,092	\$ -	\$ 11,000,000	\$ 5,756,276	\$ (5,243,724)	\$ 10,425,515	\$ 9,379,028	\$ (1,620,972)	\$ 14,238,938	\$ 10,770,383	\$ (229,617)	\$ 15,703,522
68	12		4.55%	\$ 3,699,783	\$ -	\$ 11,000,000	\$ 5,350,725	\$ (5,649,275)	\$ 9,945,373	\$ 9,628,906	\$ (1,371,094)	\$ 14,448,722	\$ 11,340,360		\$ 16,250,253
69	13		4.53%	\$ 4,205,336	\$ -	\$ 11,000,000	\$ 4,898,068	\$ (6,101,932)	\$ 9,415,647	\$ 9,870,947	\$ (1,129,054)	\$ 14,650,256	\$ 11,930,321		\$ 16,818,019
70	14		4.54%	\$ 4,711,412	\$ -	\$ 11,000,000	\$ 4,392,387	\$ (6,607,613)	\$ 8,830,106	\$ 10,093,776	\$ (906,224)	\$ 14,831,568	\$ 12,530,620		\$ 17,396,667
71	15		4.54%	\$ 5,217,708	\$ -	\$ 11,000,000	\$ 3,826,813	\$ (7,173,187)	\$ 8,181,519	\$ 10,291,853	\$ (708,147)	\$ 14,986,824	\$ 13,137,383		\$ 17,982,119
72	16		4.47%	\$ 5,716,292	\$ -	\$ 11,000,000	\$ 3,195,252	\$ (7,804,748)	\$ 7,463,423	\$ 10,475,577	\$ (524,423)	\$ 15,126,923	\$ 13,762,869		\$ 18,587,230
73	17		4.45%	\$ 6,213,019	\$ -	\$ 11,000,000	\$ 2,441,965	\$ (8,558,035)	\$ 6,670,489	\$ 10,566,188	\$ (433,812)	\$ 15,222,303	\$ 14,330,083		\$ 19,184,298
74	18		4.43%	\$ 6,707,375	\$ -	\$ 11,000,000	\$ 1,614,724	\$ (9,385,276)	\$ 5,799,709	\$ 10,624,567	\$ (375,750)	\$ 15,283,421	\$ 14,901,311		\$ 19,785,591
75	19		4.41%	\$ 7,198,844	\$ -	\$ 11,000,000	\$ 713,485	\$ (10,286,515)	\$ 4,851,037	\$ 10,647,567	\$ (352,433)	\$ 15,307,965	\$ 15,476,284		\$ 20,390,825
76	20		4.38%	\$ 7,686,939	\$ (11,000,000)	\$ -							\$ 4,819,605		\$ 20,390,825
77	21												\$ 4,758,787		\$ 15,000,000

If we distill to the most relevant information – we can compare the models as follows:

	Carrier 1			Carrier 2			Carrier 3		
	Guaranteed	Alternative	Illustrated	Guaranteed	Midpoint	Illustrated	Guaranteed	Midpoint	Illustrated
<b>Return Assumption</b>	<b>0.00%</b>	<b>2.90%</b>	<b>7.44%</b>	<b>0.00%</b>	<b>4.20%</b>	<b>6.21%</b>	<b>0.00%</b>	<b>4.20%</b>	<b>6.21%</b>
<b>Maximum Loan</b>	<b>\$ 10,781,030</b>	<b>\$ 10,781,030</b>	<b>\$ 10,781,030</b>	<b>\$ 11,695,860</b>	<b>\$ 11,695,860</b>	<b>\$ 11,695,860</b>	<b>\$ 11,695,860</b>	<b>\$ 11,695,860</b>	<b>\$ 11,695,860</b>
<b>Crossover Year/Unwind</b>	<b>13</b>	<b>N/A</b>	<b>N/A</b>	<b>12</b>	<b>N/A</b>	<b>N/A</b>	<b>12</b>	<b>N/A</b>	<b>N/A</b>
<b>Interest Paid</b>	<b>\$ 4,121,623</b>	<b>\$ 7,055,542</b>	<b>\$ 7,533,920</b>	<b>\$ 3,933,831</b>	<b>\$ 7,654,243</b>	<b>\$ 8,173,215</b>	<b>\$ 3,933,831</b>	<b>\$ 7,654,243</b>	<b>\$ 8,173,215</b>
<b>Net Death Benefit</b>	<b>\$ 10,383,151</b>	<b>\$ 13,203,199</b>	<b>\$ 15,000,000</b>	<b>\$ 9,809,922</b>	<b>\$ 14,702,533</b>	<b>\$ 15,000,000</b>	<b>\$ 9,809,922</b>	<b>\$ 14,702,533</b>	<b>\$ 15,000,000</b>
<b>Lapse Age</b>	<b>76</b>	<b>76</b>	<b>100</b>	<b>75</b>	<b>76</b>	<b>100</b>	<b>75</b>	<b>76</b>	<b>100</b>
<b>Peak Collateral</b>	<b>\$ (6,121,755)</b>	<b>\$ (3,671,012)</b>	<b>\$ (1,846,850)</b>	<b>\$(10,820,678)</b>	<b>\$ (2,435,653)</b>	<b>\$ (1,298,388)</b>	<b>\$(10,820,678)</b>	<b>\$ (2,435,653)</b>	<b>\$ (1,298,388)</b>
<b>Loan Repayment amount</b>	<b>N/A</b>	<b>N/A</b>	<b>10781029</b>	<b>N/A</b>	<b>N/A</b>	<b>\$ 11,695,860</b>	<b>N/A</b>	<b>N/A</b>	<b>\$ 11,695,860</b>
<b>Loan Repayment year</b>	<b>N/A</b>	<b>N/A</b>	<b>20</b>	<b>N/A</b>	<b>N/A</b>	<b>20</b>	<b>N/A</b>	<b>N/A</b>	<b>20</b>

<sup>1</sup> Assumes transaction unwound when the sum of the interest paid and collateral pledged is greater than the net death benefit.

Clearly the outcomes vary depending on the client's objectives. Is the client looking for the policy most likely to last to age 100? Is he or she looking to minimize collateral? Premium payments? Fundamentally there is no "right" solution. What is critical is to understand what the variance could be – what the carriers actual history is and then benchmark every year. Remember carrier illustrations are linear. There is no Monte-Carlo analysis available from the carriers.

Note the significant variance in collateral need (with all three carriers) under a performing and underperforming scenario. Further, the bank applies advance rates. That collateral number is in absolute dollars and needs to be grossed up Day One and the client needs to have the financial flexibility to meet a downside collateral fluctuation over the lifecycle of the strategy. It is often argued that the guaranteed returns and costs are over-reaching, which is a legitimate argument, but it is the best tool the carrier provides to book end for analysis purposes.

The complexity on top of caps and participations increase if a client wants to capitalize interest. For every dollar a client capitalizes, there is additional pressure on the policy to perform. Underperformance, especially in the early years has an outsized negative impact on collateral and performance over the life of the strategy. Is the answer simply to pay for the interest out of pocket? If a strategy is designed poorly, a client could end up paying more out of pocket in interest expense than he or she would have paid in premium.

Using Carrier 1 modeling – the table below illustrates the consequences of electing to capitalize interest (not all carriers permit this):

Age	Year	Loan Draw	Interest Rate	Cumulative Capitalized Interest	Loan Repayment	Year End Loan Balance	CSV @ 95%	Collateral Shortfall	Net Cash to Trust	CSV @ 95%	Collateral Shortfall	Net Cash to Trust	CSV @ 95%	Collateral Shortfall	Net Cash to Trust
57	1	\$ 1,078,103	3.62%	\$ 39,538	\$ -	\$ 1,117,641	\$ -	\$(1,117,641)	\$ 16,050,827	\$ -	\$(1,117,641)	\$ 16,139,763	\$ -	\$(1,117,641)	\$ 16,177,537
58	2	\$ 1,078,103	4.11%	\$ 131,060	\$ -	\$ 2,287,266	\$ 507,754	\$(1,779,512)	\$ 15,539,212	\$ 697,443	\$(1,589,823)	\$ 15,738,885	\$ 804,307	\$(1,482,959)	\$ 15,851,373
59	3	\$ 1,078,103	4.27%	\$ 276,798	\$ -	\$ 3,511,107	\$ 1,137,176	\$(2,373,931)	\$ 14,961,420	\$ 1,453,069	\$(2,058,038)	\$ 15,293,939	\$ 1,669,068	\$(1,842,039)	\$ 15,521,307
60	4	\$ 1,078,103	4.30%	\$ 476,825	\$ -	\$ 4,789,237	\$ 1,768,530	\$(3,020,707)	\$ 14,611,874	\$ 2,231,871	\$(2,557,366)	\$ 14,802,601	\$ 2,598,385	\$(2,190,852)	\$ 15,188,405
61	5	\$ 1,078,103	4.30%	\$ 732,512	\$ -	\$ 6,123,027	\$ 2,367,130	\$(3,755,896)	\$ 13,594,689	\$ 2,999,331	\$(3,123,696)	\$ 14,260,163	\$ 3,561,075	\$(2,561,952)	\$ 14,851,473
62	6	\$ 1,078,103	4.34%	\$ 1,049,634	\$ -	\$ 7,518,252	\$ 2,970,030	\$(4,548,222)	\$ 12,801,095	\$ 3,812,968	\$(3,705,283)	\$ 13,688,399	\$ 4,621,768	\$(2,896,484)	\$ 14,539,767
63	7	\$ 1,078,103	4.40%	\$ 1,432,789	\$ -	\$ 8,979,510	\$ 3,582,526	\$(5,396,984)	\$ 11,918,570	\$ 4,685,745	\$(4,293,765)	\$ 13,079,853	\$ 5,797,107	\$(3,182,403)	\$ 14,249,708
64	8	\$ 1,078,103	4.42%	\$ 1,883,332	\$ -	\$ 10,508,156	\$ 4,187,738	\$(6,320,418)	\$ 10,944,489	\$ 5,602,970	\$(4,905,186)	\$ 12,434,207	\$ 7,078,157	\$(3,429,999)	\$ 13,987,036
65	9	\$ 1,078,103	4.46%	\$ 2,407,740	\$ -	\$ 12,110,667	\$ 4,768,620	\$(7,342,047)	\$ 9,870,933	\$ 6,549,992	\$(5,560,675)	\$ 11,746,061	\$ 8,456,529	\$(3,654,138)	\$ 13,752,942
66	10	\$ 1,078,103	4.51%	\$ 3,010,562	\$ -	\$ 13,791,592	\$ 5,324,907	\$(8,466,685)	\$ 8,693,073	\$ 7,527,868	\$(6,263,723)	\$ 11,011,980	\$ 9,940,097	\$(3,851,495)	\$ 13,551,168
67	11	\$ 1,078,103	4.54%	\$ 3,645,929	\$ -	\$ 14,426,959	\$ 4,998,849	\$(9,428,110)	\$ 7,648,487	\$ 7,573,016	\$(6,853,943)	\$ 10,358,137	\$ 10,531,403	\$(3,895,556)	\$ 13,472,228
68	12	\$ 1,078,103	4.55%	\$ 4,311,787	\$ -	\$ 15,092,817	\$ 4,659,275	\$(10,433,542)	\$ 6,542,683	\$ 7,613,855	\$(7,478,962)	\$ 9,652,767	\$ 11,161,337	\$(3,896,959)	\$ 13,386,959
69	13	\$ 1,078,103	4.53%	\$ 5,005,443	\$ -	\$ 15,786,473	\$ 4,289,897	\$(11,496,576)	\$ 5,377,708	\$ 7,642,600	\$(8,143,873)	\$ 8,906,869	\$ 11,824,891	\$(3,896,281)	\$ 13,309,281
70	14	\$ 1,078,103	4.54%	\$ 5,731,730	\$ -	\$ 16,512,760	\$ 3,885,101	\$(12,627,659)	\$ 4,142,820	\$ 7,646,354	\$(8,866,406)	\$ 8,102,034	\$ 12,512,023	\$(3,896,281)	\$ 13,223,791
71	15	\$ 1,078,103	4.54%	\$ 6,491,761	\$ -	\$ 17,272,791	\$ 3,425,000	\$(13,847,792)	\$ 2,832,472	\$ 7,605,776	\$(9,667,015)	\$ 7,233,289	\$ 13,206,128	\$(3,896,281)	\$ 13,128,396
72	16	\$ 1,078,103	4.47%	\$ 7,274,664	\$ -	\$ 18,055,694	\$ 2,934,196	\$(15,121,499)	\$ 1,532,933	\$ 7,549,971	\$(10,505,723)	\$ 6,391,644	\$ 13,941,030	\$(3,896,281)	\$ 13,119,074
73	17	\$ 1,078,103	4.45%	\$ 8,090,006	\$ -	\$ 18,871,036	\$ 2,388,529	\$(16,482,507)	\$ 143,205	\$ 7,452,751	\$(11,418,285)	\$ 5,473,965	\$ 14,695,053	\$(3,896,281)	\$ 13,097,441
74	18	\$ 1,078,103	4.43%	\$ 8,938,098	\$ -	\$ 19,719,128	\$ 1,719,128	\$(18,000,000)	\$ 0	\$ 7,308,204	\$(12,410,924)	\$ 4,473,718	\$ 15,465,212	\$(3,896,281)	\$ 13,060,603
75	19	\$ 1,078,103	4.41%	\$ 9,819,129	\$ -	\$ 20,600,159	\$ 0	\$(20,600,159)	\$ 0	\$ 7,110,018	\$(13,490,142)	\$ 3,384,070	\$ 16,248,083	\$(3,896,281)	\$ 13,003,086
76	20	\$ 1,078,103	4.38%	\$ 10,733,206	\$(10,781,029)	\$ 10,733,206	\$ 0	\$(10,733,206)	\$ 0	\$ 0	\$ 0	\$ 5,970,013	\$ 0	\$(3,896,281)	\$ 12,924,948
77	21	\$ 1,078,103	4.38%	\$ 11,733,206	\$ 0	\$ 11,733,206	\$ 0	\$(11,733,206)	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$(3,896,281)	\$ 12,846,744

If interest is capitalized, there is a \$10,000,000 residual loan and \$4,000,000 of net death benefit. The above example is a tobacco smoker, which will make capitalized interest near impossible.

Shown next is the Carrier 1 policy design for premium finance with capitalized interest. The underwriting is at super preferred non-smoker – age 57 male.



Insured		Super Perferred Male Non Smoker age 57														
Carrier		Carrier 1														
Policy Type		IUL														
Loan		Year End Loan Balance														
Age	Year	Loan Draw	Interest Rate	Cumulative Capitalized Interest	Loan Repayment	CSV @ 95%	Collateral Shortfall	Net Cash to Trust	CSV @ 95%	Collateral Shortfall	Net Cash to Trust	CSV @ 95%	Collateral Shortfall	Net Cash to Trust		
57	1	\$ 1,914,592	3.62%	\$ 70,215	\$ -	\$ 1,984,807	\$ -	\$ (1,984,807)	\$ 15,183,661	\$ 240,721	\$ (1,744,085)	\$ 26,356,084	\$ 306,898	\$ (1,677,908)	\$ 26,425,744	
58	2	\$ 1,914,592	4.11%	\$ 232,749	\$ -	\$ 4,061,933	\$ 1,147,598	\$ (2,914,335)	\$ 13,764,545	\$ 1,825,095	\$ (2,236,838)	\$ 25,919,970	\$ 2,027,212	\$ (2,034,721)	\$ 26,132,724	
59	3	\$ 1,914,592	4.27%	\$ 491,563	\$ -	\$ 6,235,339	\$ 2,368,359	\$ (3,866,980)	\$ 12,237,188	\$ 3,483,998	\$ (2,751,341)	\$ 25,439,277	\$ 3,899,047	\$ (2,336,292)	\$ 25,876,171	
60	4	\$ 1,914,592	4.30%	\$ 846,789	\$ -	\$ 8,505,157	\$ 3,541,430	\$ (4,963,727)	\$ 10,895,954	\$ 5,168,151	\$ (3,337,006)	\$ 24,915,502	\$ 5,880,964	\$ (2,624,193)	\$ 25,665,831	
61	5	\$ 1,914,592	4.30%	\$ 1,300,860	\$ -	\$ 10,873,820	\$ 4,712,230	\$ (6,161,590)	\$ 8,843,896	\$ 6,929,975	\$ (3,943,844)	\$ 24,347,891	\$ 8,033,867	\$ (2,839,953)	\$ 25,509,882	
62	6	\$ 1,914,592	4.34%	\$ 1,864,034	\$ -	\$ 13,351,586	\$ 5,841,751	\$ (7,509,835)	\$ 6,967,761	\$ 8,782,634	\$ (4,568,952)	\$ 23,793,542	\$ 10,387,288	\$ (2,964,298)	\$ 25,482,642	
63	7	\$ 1,914,592	4.40%	\$ 2,544,476	\$ -	\$ 15,946,620	\$ 7,038,106	\$ (8,908,513)	\$ 4,951,460	\$ 10,806,387	\$ (5,140,233)	\$ 23,195,024	\$ 13,030,689	\$ (2,915,930)	\$ 25,536,395	
64	8	\$ -	4.42%	\$ 3,258,824	\$ -	\$ 16,660,968	\$ 6,702,461	\$ (9,958,507)	\$ 4,791,677	\$ 11,203,036	\$ (5,457,932)	\$ 22,764,451	\$ 14,108,270	\$ (2,552,697)	\$ 25,822,593	
65	9	\$ -	4.46%	\$ 4,012,918	\$ -	\$ 17,415,062	\$ 6,324,040	\$ (11,091,022)	\$ 4,566,538	\$ 11,609,929	\$ (5,805,133)	\$ 22,304,916	\$ 15,262,753	\$ (2,152,309)	\$ 26,149,994	
66	10	\$ -	4.51%	\$ 4,808,913	\$ -	\$ 18,211,057	\$ 5,876,989	\$ (12,334,068)	\$ 4,273,608	\$ 12,002,045	\$ (6,209,011)	\$ 21,814,675	\$ 16,474,948	\$ (1,736,109)	\$ 26,522,993	
67	11	\$ -	4.54%	\$ 5,647,881	\$ -	\$ 19,050,225	\$ 5,282,852	\$ (13,767,172)	\$ 3,025,421	\$ 12,179,069	\$ (6,870,955)	\$ 20,975,707	\$ 17,465,609	\$ (1,584,415)	\$ 25,684,025	
68	12	\$ -	4.55%	\$ 6,527,110	\$ -	\$ 19,929,254	\$ 4,782,812	\$ (15,146,442)	\$ 1,706,246	\$ 12,655,634	\$ (7,273,620)	\$ 20,096,478	\$ 18,951,978	\$ (977,276)	\$ 24,804,796	
69	13	\$ -	4.53%	\$ 7,443,046	\$ -	\$ 20,845,190	\$ 4,216,321	\$ (16,628,869)	\$ 318,991	\$ 13,127,551	\$ (7,717,639)	\$ 19,180,542	\$ 20,531,239	\$ (313,950)	\$ 23,888,860	
70	14	\$ -	4.54%	\$ 8,402,069	\$ -	\$ 21,804,213	\$ 3,568,990	\$ (18,235,223)	\$ (1,148,633)	\$ 13,597,251	\$ (8,206,962)	\$ 18,221,519	\$ 22,215,228	\$ -	\$ 22,929,837	
71	15	\$ -	4.54%	\$ 9,405,650	\$ -	\$ 22,807,794	\$ 2,795,391	\$ (20,012,403)	\$ (2,702,531)	\$ 14,026,451	\$ (8,781,343)	\$ 17,217,938	\$ 23,971,807	\$ -	\$ 21,926,256	
72	16	\$ -	4.47%	\$ 10,439,431	\$ -	\$ 23,841,575	\$ 1,861,574	\$ (21,980,001)	\$ (4,252,948)	\$ 14,381,490	\$ (9,460,086)	\$ 16,184,157	\$ 25,770,756	\$ -	\$ 20,892,475	
73	17	\$ -	4.45%	\$ 11,516,046	\$ -	\$ 24,918,190	\$ 789,235	\$ (24,128,955)	\$ (5,903,949)	\$ 14,720,336	\$ (10,197,854)	\$ 15,107,542	\$ 27,705,562	\$ -	\$ 19,815,860	
74	18	\$ -	4.43%	\$ 12,635,906	\$ -	\$ 26,038,050	\$ -	\$ (26,038,050)	\$ (7,659,064)	\$ 15,308,808	\$ (10,999,242)	\$ 13,987,682	\$ 29,790,834	\$ -	\$ 18,696,000	
75	19	\$ -	4.41%	\$ 13,799,261	\$ -	\$ 27,201,405	\$ -	\$ (27,201,405)	\$ (27,201,405)	\$ 15,331,749	\$ (11,869,656)	\$ 12,824,327	\$ 32,043,826	\$ -	\$ 17,532,645	
76	20	\$ -	4.38%	\$ 13,799,261	\$ (27,201,405)	\$ -	\$ -	\$ -	\$ (27,201,405)	\$ -	\$ -	\$ -	\$ 6,752,294	\$ -	\$ 16,834,731	

	Guaranteed	Alternative	Illustrated
<b>Return Assumption</b>	<b>0.00%</b>	<b>3.14%</b>	<b>7.44%</b>
<b>Maximum Loan</b>	<b>\$ 20,845,190</b>	<b>\$ 27,201,405</b>	<b>\$ 27,201,405</b>
<b>Crossover Year Interest Paid + Collateral &gt; NDB</b>	<b>\$ 14</b>	<b>\$ 20</b>	<b>N/A</b>
<b>Interest Paid</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>
<b>Net Death Benefit</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 16,110,177</b>
<b>Lapse Age</b>	<b>76</b>	<b>77</b>	<b>100</b>
<b>Peak Collateral</b>	<b>\$ (27,201,405)</b>	<b>\$ (11,869,656)</b>	<b>\$ (2,964,298)</b>
<b>Loan Repayment amount</b>	<b>N/A</b>	<b>\$ 27,201,405</b>	<b>\$ 27,201,405</b>
<b>Loan Repayment year</b>	<b>N/A</b>	<b>20</b>	<b>20</b>

First note that the initial death benefit, and correspondingly the premium need to be significantly higher to meet the client's net death benefit objectives throughout the life of the strategy. That death benefit can be dropped after the loan is repaid. The incremental death benefit need must be justified to the carrier. Death benefit is not simply granted to allow for financing. Further, the need for the policy to perform is greater given the increased stress of the interest being capitalized. Also, it is important to remember dollars distributed above policy basis (a good proxy is premiums paid) are taxable, as noted above. To fully repay the loan without tax consequences in a capitalized interest scenario, there needs to be a policy loan against the cash surrender value in addition to basis withdrawal. That policy loan may dampen future policy performance so the need for diligent oversight continues.

One additional note on capitalized interest strategies is that often riders that artificially inflate cash surrender value (depending on carrier labeled as early cash value riders, return of premium riders, "honeymoon" provisions, executive benefit rider, etc..) are added to reduce the collateral need and make the sales material more attractive. These strategies minimize the non-insurance collateral need but have hidden pitfalls. The cost associated with the rider can effectively reduce the efficiency of the policy that is expected to perform to pay-off the loan. What happens if the policy underperforms? The client needs to either a) add collateral or b) surrender and purchase a replacement policy. What happens in the scenario when there is a change in the insured health class or the insured is no longer insurable? It becomes a vicious circle. The additional costs associated with the rider to support cash value may make the policy less efficient. If the policy is less efficient, it may underperform. If it underperforms, there will be a greater collateral need. If the client is unable to meet the collateral need, the Lender could call the loan. In short, an inability to meet a collateral call — the very thing the rider was added to protect against — could result in the loss of insurance, liquidation of collateral and potentially taxable gains from the surrender of the policy.

### Additional Examples

Is the additional work and risk associated with the best case financed scenario (A) better than paying for 20 years and being done (B)?

A							B					
Anonymous Carrier Index IUL - Year 19 Withdraw							20 Pay Anonymous Carrier Universal Life - 15M					
Year	Premium	Interest	Loan	CSV	DB	Net DB	Year	Premium	Loan	CSV	DB	Net DB
1	910,350	33,386	910,350	211,240	15,754,284	14,843,934	1	321,001	0	0	15,000,000	15,000,000
2	910,350	75,890	1,820,700	1,030,197	16,549,711	14,729,011	2	321,001	0	0	15,000,000	15,000,000
3	910,350	118,268	2,731,050	1,893,821	17,390,229	14,659,179	3	321,001	0	0	15,000,000	15,000,000
4	910,350	158,716	3,641,400	2,805,149	18,278,878	14,637,478	4	321,001	0	0	15,000,000	15,000,000
5	910,350	198,356	4,551,750	3,769,529	19,221,145	14,669,395	5	321,001	0	0	15,000,000	15,000,000
6	910,350	240,539	5,462,100	4,807,754	20,218,309	14,756,209	6	321,001	0	0	15,000,000	15,000,000
7	910,350	284,032	6,372,450	5,899,616	21,269,111	14,896,661	7	321,001	0	0	15,000,000	15,000,000
8	910,350	326,242	7,282,800	7,137,855	22,466,290	15,183,490	8	321,001	0	0	15,000,000	15,000,000
9		329,628	7,282,800	7,541,269	22,466,290	15,183,490	9	321,001	0	0	15,000,000	15,000,000
10		332,877	7,282,800	7,957,457	22,466,290	15,183,490	10	321,001	0	0	15,000,000	15,000,000
11		335,512	7,282,800	8,491,471	22,466,290	15,183,490	11	321,001	0	0	15,000,000	15,000,000
12		336,128	7,282,800	9,052,858	22,466,290	15,183,490	12	321,001	0	0	15,000,000	15,000,000
13		334,713	7,282,800	9,642,084	22,466,290	15,183,490	13	321,001	0	0	15,000,000	15,000,000
14		335,059	7,282,800	10,262,011	22,466,290	15,183,490	14	321,001	0	0	15,000,000	15,000,000
15		335,205	7,282,800	10,915,920	22,466,290	15,183,490	15	321,001	0	0	15,000,000	15,000,000
16		330,099	7,282,800	11,608,505	22,466,290	15,183,490	16	321,001	0	0	15,000,000	15,000,000
17		328,870	7,282,800	12,296,400	22,466,290	15,183,490	17	321,001	0	0	15,000,000	15,000,000
18		327,300	7,282,800	13,026,841	22,466,290	15,183,490	18	321,001	0	0	15,000,000	15,000,000
19	-7,282,800	325,388	0	5,989,763	15,183,490	15,183,490	19	321,001	0	0	15,000,000	15,000,000
20				6,227,660	15,183,490	15,183,490	20	321,001	0	0	15,000,000	15,000,000
21				6,471,460	15,183,490	15,183,490	21		0	0	15,000,000	15,000,000
Estimated Cumulative Int		5,086,200					Est Premiums Paid:					6,420,020
Projected Lapse:		Age 102					Projected Lapse:					Age 120
Projected Death Benefit:		15,183,490					Projected Death Benefit:					15,000,000
Projected Lapse		102										

In the above example by Year 8 the interest on the loan exceeds the annual premium that would be paid in a level pay scenario. Further, that interest payment continues for 11 years based on current LIBOR assumptions and crediting rates. That 11 years can be lengthened or shortened by any risk variable and would have a corresponding effect on the collateral need.

Another basic pitfall is flat death benefit which is often overlooked. What happens if the loan is increasing and the death benefit is flat rather than increasing? There are in-force strategies that have been designed with a flat death benefit and capitalized interest.

One opinion is that Whole Life with interest paid out of pocket is a more dependable strategy. Below is an example of a financed Whole Life policy:

Loan		Cumulative Interest Out of Pocket		Year End Loan Balance		CSV @ 95%	Collateral Shortfall	Net Cash to Trust	CSV @ 95%	Collateral Shortfall	Net Cash to Trust	CSV @ 95%	Collateral Shortfall	Net Cash to Trust	
Age	Year	Loan Draw	Interest Rate	Pocket	Repayment										
57	1	\$ 1,029,000	3.62%	\$ 37,737	\$ -	\$ 1,029,000	\$ 329,318	\$ (699,683)	\$ 13,971,000	\$ 329,318	\$ (699,683)	\$ 13,971,000	\$ 329,318	\$ (699,683)	\$ 13,971,000
58	2	\$ 1,029,000	4.11%	\$ 123,518	\$ -	\$ 2,058,000	\$ 905,730	\$ (1,152,270)	\$ 12,942,000	\$ 941,355	\$ (1,116,645)	\$ 13,023,153	\$ 976,980	\$ (1,081,020)	\$ 13,104,306
59	3	\$ 1,029,000	4.27%	\$ 257,201	\$ -	\$ 3,087,000	\$ 1,703,303	\$ (1,383,698)	\$ 11,913,000	\$ 1,778,918	\$ (1,308,082)	\$ 12,080,328	\$ 1,855,324	\$ (1,231,676)	\$ 12,249,408
60	4	\$ 1,029,000	4.30%	\$ 436,603	\$ -	\$ 4,116,000	\$ 2,529,233	\$ (1,586,768)	\$ 10,884,000	\$ 2,650,239	\$ (1,465,761)	\$ 11,144,226	\$ 2,773,687	\$ (1,342,314)	\$ 11,409,700
61	5	\$ 1,029,000	4.30%	\$ 660,811	\$ -	\$ 5,145,000	\$ 3,384,233	\$ (1,760,768)	\$ 9,855,000	\$ 3,558,193	\$ (1,586,807)	\$ 10,218,750	\$ 3,737,259	\$ (1,407,741)	\$ 10,593,180
62	6	\$ 1,029,000	4.34%	\$ 932,701	\$ -	\$ 6,174,000	\$ 4,268,873	\$ (1,905,128)	\$ 8,826,000	\$ 4,509,268	\$ (1,664,732)	\$ 9,315,086	\$ 4,758,674	\$ (1,415,327)	\$ 9,822,501
63	7	\$ 1,029,000	4.40%	\$ 1,253,752	\$ -	\$ 7,203,000	\$ 5,186,145	\$ (2,016,855)	\$ 7,797,000	\$ 5,507,027	\$ (1,695,973)	\$ 8,432,649	\$ 5,842,398	\$ (1,360,602)	\$ 9,096,997
64	8	\$ 1,029,000	4.42%	\$ 1,622,514	\$ -	\$ 8,232,000	\$ 6,139,470	\$ (2,092,530)	\$ 6,768,000	\$ 6,555,403	\$ (1,676,597)	\$ 7,570,742	\$ 6,993,224	\$ (1,238,776)	\$ 8,415,728
65	9	\$ 1,029,000	4.46%	\$ 2,041,678	\$ -	\$ 9,261,000	\$ 7,133,550	\$ (2,127,450)	\$ 5,739,000	\$ 7,659,712	\$ (1,601,288)	\$ 6,728,964	\$ 8,217,567	\$ (1,043,434)	\$ 7,778,555
66	10	\$ 1,029,000	4.51%	\$ 2,512,005	\$ -	\$ 10,290,000	\$ 8,173,800	\$ (2,116,200)	\$ 4,710,000	\$ 8,824,079	\$ (1,465,921)	\$ 5,903,348	\$ 9,518,556	\$ (771,444)	\$ 7,177,805
67	11		4.54%	\$ 2,986,057	\$ -	\$ 10,290,000	\$ 8,377,148	\$ (1,912,853)	\$ 4,710,000	\$ 9,147,111	\$ (1,142,889)	\$ 6,088,686	\$ 9,976,972	\$ (313,028)	\$ 7,574,623
68	12		4.55%	\$ 3,460,978	\$ -	\$ 10,290,000	\$ 8,582,205	\$ (1,707,795)	\$ 4,710,000	\$ 9,475,236	\$ (814,764)	\$ 6,270,842	\$ 10,446,974	\$ -	\$ 7,969,249
69	13		4.53%	\$ 3,933,900	\$ -	\$ 10,290,000	\$ 8,789,685	\$ (1,500,315)	\$ 4,710,000	\$ 9,810,158	\$ (479,842)	\$ 6,451,483	\$ 10,931,838	\$ -	\$ 8,365,682
70	14		4.54%	\$ 4,407,312	\$ -	\$ 10,290,000	\$ 8,998,733	\$ (1,291,268)	\$ 4,710,000	\$ 10,151,971	\$ -	\$ 6,632,335	\$ 11,432,311	\$ -	\$ 8,766,536
71	15		4.54%	\$ 4,880,929	\$ -	\$ 10,290,000	\$ 9,208,778	\$ (1,081,223)	\$ 4,710,000	\$ 10,498,650	\$ -	\$ 6,811,047	\$ 11,945,017	\$ -	\$ 9,167,007
72	16		4.47%	\$ 5,347,331	\$ -	\$ 10,290,000	\$ 9,416,828	\$ (873,173)	\$ 4,710,000	\$ 10,850,616	\$ -	\$ 6,993,872	\$ 12,474,168	\$ -	\$ 9,580,017
73	17		4.45%	\$ 5,811,997	\$ -	\$ 10,290,000	\$ 9,623,595	\$ (666,405)	\$ 4,710,000	\$ 11,207,408	\$ -	\$ 7,178,641	\$ 13,017,739	\$ -	\$ 10,000,348
74	18		4.43%	\$ 6,274,444	\$ -	\$ 10,290,000	\$ 9,829,365	\$ (460,635)	\$ 4,710,000	\$ 11,568,991	\$ -	\$ 7,364,737	\$ 13,576,255	\$ -	\$ 10,427,902
75	19		4.41%	\$ 6,734,192	\$ -	\$ 10,290,000	\$ 10,033,995	\$ (256,005)	\$ 4,710,000	\$ 11,933,553	\$ -	\$ 7,549,684	\$ 14,145,384	\$ -	\$ 10,856,189
76	20		4.38%	\$ 7,190,782	\$ (10,290,000)					\$ 1,680,814	\$ -	\$ 6,037,279	\$ 4,504,052	\$ -	\$ 9,053,262
77	21			\$ 7,190,782						\$ 1,125,334	\$ -	\$ 5,280,099	\$ 4,629,479	\$ -	\$ 9,052,825
78	22			\$ 7,190,782						\$ -	\$ -	\$ 4,435,039	\$ 4,751,096	\$ -	\$ 9,046,494
79	23			\$ 7,190,782						\$ -	\$ -	\$ 3,877,829	\$ 4,867,692	\$ -	\$ 9,034,804
89	32	\$ 1,012,522		\$ 7,190,782								\$ 2,575,893	\$ 8,627,698		



	Guaranteed	Alternative	Illustrated
Return Assumption	0.00%	3.20%	6.40%
Maximum Loan	\$10,290,000	\$10,290,000	\$10,290,000
Crossover Year Interest Paid + Collateral > NDB	\$ 11	\$ 17	N/A
Interest Paid	\$ 2,986,057	\$ 5,811,997	\$ 7,190,782
Net Death Benefit	\$ 4,710,000	\$ 7,178,641	\$ 9,034,804
Lapse Age	76	73	121
Peak Collateral	\$ (2,127,450)	\$ (1,695,973)	\$ (1,415,327)
Loan Repayment amount	N/A	N/A	\$10,290,000
Loan Repayment year	N/A	N/A	20

On a positive note, even under the guaranteed return scenario the collateral need reduces with the passage of time. The collateral requirement goes away in Year 14 under the midpoint scenario. There is repayment opportunity under the midpoint return scenario but does this mean it is a better strategy? Net cash to the trust is \$3.8MM in the midpoint scenario and \$9.0MM in the performing scenario – but that ignores the \$7.2MM in interest paid.

What is not shown above is that to repay the loan under either a performing or midpoint scenario and continue death benefit, there is not full cost recovery but partial surrender of \$4.3MM and a policy loan of \$6MM. The policy loan effectively dampens the growth rate of the cash value.

Under the midpoint scenario, to keep any death benefit past age 82, the insured must pay additional premium starting at \$328M in Year 24 and growing to over \$1MM annually beginning Year 32. At that point, net death benefit, without taking into account interest paid, is \$2.5MM.

Financing doesn't have to be from a third party Lender. An intrafamily loan is another form of financing, and the lender is probably going to be more flexible than a bank.

There is no single answer; there is no secret sauce. The benefits can be significant — but like any other planning solution, it needs to be monitored. Working with an experienced team across the Insurance, Estate and Banking practices to optimize client outcome is critical.

*This material is provided for illustrative/educational purposes only. This material is not intended to constitute legal, tax, investment or financial advice. Effort has been made to ensure that the material presented herein is accurate at the time of publication. However, this material is not intended to be a full and exhaustive explanation of the law in any area or of all of the tax, investment or financial options available. The information discussed herein may not be applicable to or appropriate for every investor and should be used only after consultation with professionals who have reviewed your specific situation.*



## 44th Annual Notre Dame Tax and Estate Planning Institute

### Panel: Life Insurance Product Selection, Design and Funding: Understanding Misleading Policy Illustrations, Alternatives to Policy Illustrations, and Correcting Failed Products

#### Case Studies

#### Premium Finance – Key Elements Summary:

## 1759 Consulting

<b>Strategy Name:</b>	<b>Premium Finance</b>				
<b>Key Steps:</b>					
Confidentiality Protocols ➡ Data Collection & Analysis ➡ Advisory Team Coordination ➡ Placement of Coverage ➡ Annual Service					
<b>Preliminary Client Requests:</b>	Projected Net Death Benefit <b>XXX</b>	<i>Projected Annual Premium</i> <b>XXXXXXXX</b>	Projected Loan Amount <b>XXXXX</b>	Estimated Life Expectancy (LE) <b>XXXX</b>	Estimated Budget for Interest Payments and Collateral
<b>Non-Controllable Risk Elements:</b>			<b>Trap Doors:</b>		
<ul style="list-style-type: none"> <li>Future net worth of client (ability to post additional collateral, interest payments)</li> <li>Future financial rating of Carrier (cash surrender value as collateral)</li> <li>Future performance of product (collateral, exit strategy, net death benefit)</li> <li>Future interest rate movement (size of interest payments)</li> <li>Loan Renewal (will the lender renew the loan at end of period)</li> <li>Lender's commitment to this type of business</li> </ul>			<ul style="list-style-type: none"> <li>Financing of VUL (See Reg. U, 40 Act, 1934 Act)</li> <li>Accrued Interest (will Carrier allow)</li> <li>Interest payments (advance or arrears)</li> <li>Interest rate (type of LIBOR, Prime, spreads, swaps, breakage fees)</li> <li>Form of additional collateral</li> <li>Engineered Illustrations</li> <li>Gratuitous use of credit</li> </ul>		
<b>Modeling Considerations:</b>		<b>Key Documents</b>		<b>Target Date</b>	
<ol style="list-style-type: none"> <li>1) Interest rate sensitivity (multiple loan interest rates)</li> <li>2) Cash surrender value collateral value modeled at different advance rates</li> <li>3) Multiple loan repayment options (exit strategies)</li> <li>4) Type of life insurance be modeled</li> <li>5) Copy of life insurance illustration that is modeled</li> <li>6) Annual exclusions available</li> <li>7) Lifetime exemption available</li> <li>8) IRR of net benefit at LE and selected ages</li> </ol>		Trust Document		TBD	
		Loan Documents		TBD	
		Lender Loan Model		TBD	
		Life Insurance Illustrations		TBD	

#### Overview:

We will discuss, analyze, and offer possible solutions to several of the most common problems with premium financed life insurance policies. The case studies discussed are a collection of actual and or hypothetical situations we as a panel have encountered. We will address the individual elements that created the problem(s).

#### Marketplace Observations:

**Financial crisis of 2008:** The financial crisis of 2008 created a unique set of circumstances for financed life insurance transactions. Almost all the life insurance companies experienced a reduction in their

financial ratings. Fortunately, through the regulations regarding the reserving requirements imposed on life insurance companies the majority of cash surrender value of policies was still an acceptable form of collateral for the outstanding loans.

***Declining interest rate environment:*** Over the past ten years we have seen a declining interest rate environment. At times short term rates exceeded the long-term rates available in the marketplace. As a result, we have witnessed a reduction in crediting rates across all policies types. These reduced crediting rates created an adverse impact on long term policy performance. Today as we witness increasing interest rates, the crediting rates on policies still lags. Historical observations imply a two-year window in an increasing interest rate environment before increases in policy crediting rates are applied to in-force policies.

***Stock market:*** We are currently in the longest running bull market in history. This has allowed individuals and companies to recover losses sustained in 2008. In fact, many individuals and companies maintain extremely large cash or liquid positions.

***Life insurance companies:*** Over the past decade life insurance companies have created and released new product types. Most notably is the rise in popularity of indexed universal life insurance products.

***Tax law changes:*** Over the course of the last two presidential administrations we have seen significant movement in both income tax and estate planning tax policies. The current lifetime and annual exemption amounts provide added flexibility in the execution of planning strategies.

### **Case Study:**

Client is currently financing 4 policies with a lender. The loan rate is fixed for 10 years, and the client is 4 years into the deal. Variable loan rates have dropped and client wants to refinance. However, per the loan documents, breaking the loan would cost over \$1MM.

The client wants to consolidate coverage and refinance his existing deal.

Take the existing financing structure and transition it to a more efficient structure from both a cash flow, collateral and net death benefit coverage perspective.

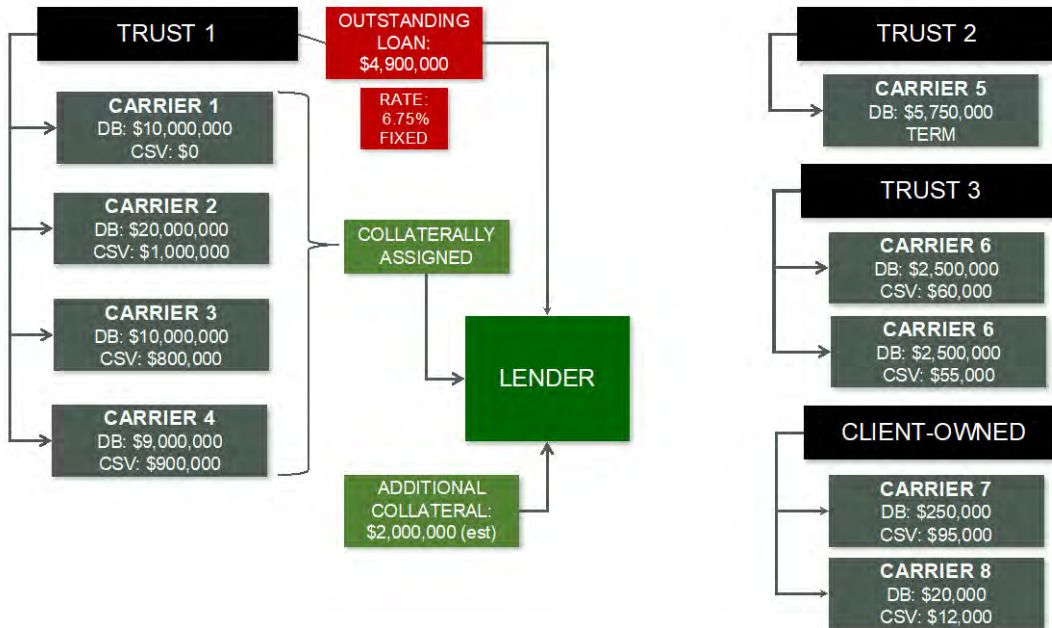
### ***FACTS***

- ◇ Client currently has 9 policies, different ownership
- ◇ Client is currently financing 4 policies
- ◇ Existing loan has interest due
- ◇ Current loan has 6.75% fixed rate, breakage fee of \$1M
- ◇ Client intends to consolidate coverage into 2 policies
- ◇ Net worth 100M plus
- ◇ Age: 60

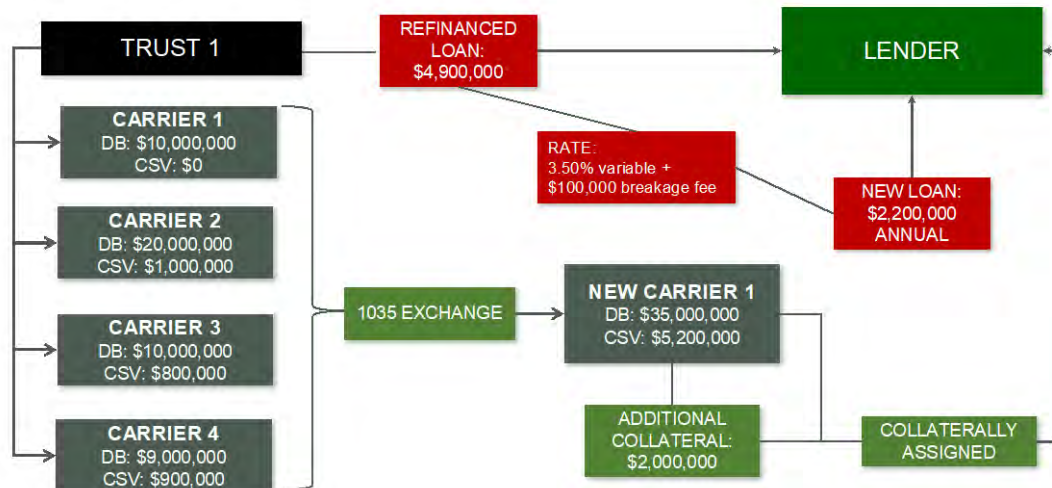
### ***ASSUMPTIONS***

- ◇ Client is healthy and insurable
- ◇ Current loan is in good standing

# ANALYZE CURRENT SITUATION



## CONSOLIDATE COVERAGE, REFINANCE LOAN





## Risks:

### UNDERWRITING CAPACITY

- Jumbo Limits
  - New Carrier 1 -- \$50MM
  - New Carrier 2 -- \$65MM
- Current Coverage -- \$85MM
- Amount Applied -- \$54MM

### LOAN RENEGOTIATION

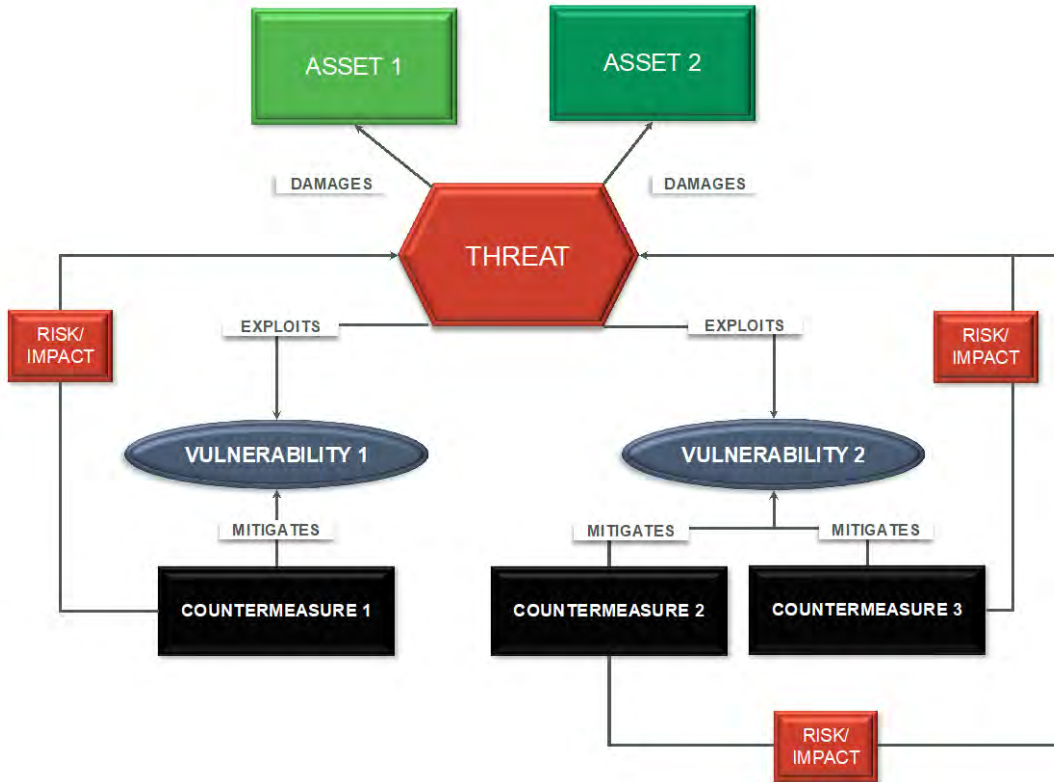
- Original breakage fee -- \$1MM
- New Loan Terms
  - \$100,000 breakage fee
  - 5-year additional breakage fee schedule
  - New loan rate of PRIME + 25 bps
  - 5 year term

### 1035 COORDINATION

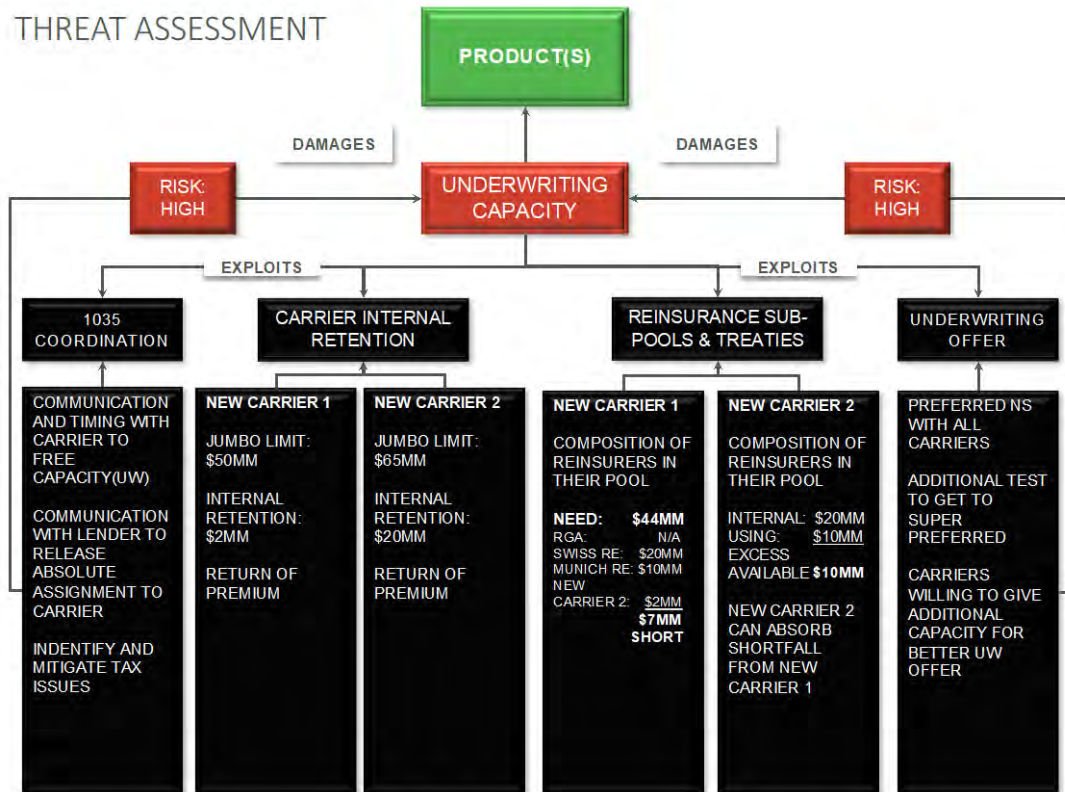
- Lender
  - Will not release policy assignment without executed amended promissory note and breakage fee
- Carrier
  - Must consider that new coverage will be replacing and reducing existing coverage
- Borrower (Client/Trust)
  - Needs 1035 exchange to go into appropriate policies; cannot surrender existing coverage until new coverage in place and ready

### FINANCIAL STMTS/LEGAL STRUCTURE

- Lender
- Trust 1: no financial statement
  - Trust 1 used solely for financed policies
- Client intends to restructure ownership of policies within trust
  - Could affect 1035 exchanges



### THREAT ASSESSMENT





# IMPLEMENTATION & FUNDING

