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# DUE CARE BULLETIN

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## An Assessment of Face Amount Reductions in Today's Marketplace

As a result of the financial turbulence in today's economy, policyholders may have smaller projected estate values or less cash on hand to pay insurance premiums. This has led some policyholders, and their advisors, to consider reducing the face amounts of existing policies. While a face reduction appears on the surface to be a simple and easy solution, there are a number of factors to evaluate, including product restrictions and charges.

This M Due Care Bulletin will address face amount reductions, including considerations such as partial surrender charges and additional required premium, as well as alternatives to face amount reductions such as extended term.

### Face Amount Reduction Considerations

While the economic downturn has had an impact on the net worths of many clients, it is important to consider the following factors before taking action to reduce the face amount of an existing policy.

- **Health of Insured:** Keeping the original death benefit may be more valuable if the policyholder's health has deteriorated.
- **Economic Rebound:** The amount of future death benefit a policyholder needs may rebound in an economic recovery; depressed estate values and a lack of liquidity may only be temporary.
- **Underwriting:** If a policyholder proceeds with a face amount reduction now, but wants to increase the face amount later, new underwriting will be required. At best this requires additional work and time for both the policyholder and the advisor. At worst the client will be faced with a cost increase for the additional coverage, or may even be denied coverage due to deteriorating health.
- **Beneficiaries:** By keeping the original face amount, the full target value will ultimately be received by the beneficiaries (i.e., full death benefit value is preserved for the beneficiaries).
- **Extended Term:** If cash is not readily available to fund future premiums, consider extended term. Extended term preserves the original face amount but reduces or eliminates future premiums by reducing the number of years of death benefit coverage. Inforce rejections are required to evaluate the reduced term of death benefit coverage, and can be used to evaluate future catch-up premiums to restore the projected death benefit coverage for life. Downside scenarios should also be reviewed to assess the leveraged impact

on

the reduced number of years of death benefit coverage. Extended term may be a reasonable option if the projected number of years of death benefit coverage

*Life insurance due care requires an understanding of the factors that impact policy performance and drive product selection.*

*M Financial Group continues to lead the industry in life insurance due care and client advocacy, providing valuable insight and analysis that delivers significant value to clients.*



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is beyond life expectancy (especially if the policyholder's health has deteriorated).

## An Assessment of Face Amount Reductions in Today's Marketplace

### Product Restrictions and Charges

A client's ability to reduce the face amount of an inforce policy may be limited by restrictions in the contract. Related product charges may also be prohibitive. The following is an overview of the restrictions and charges to consider.

- **Inforce Rejections:** Some product inforce reversion systems may not have the ability to reflect face changes and premium changes, which will create challenges in making an informed decision regarding the amount of the face reduction and the resulting impact on premium required.
- **Partial Surrender Charge:** Some products assess a partial surrender charge for face amount reductions. If the partial surrender charge exceeds the policy's cash value (or shadow account for NLG), additional premium is typically required in order to restore the account to positive. At the very least, the partial surrender charge will reduce the account value (or shadow account for NLG).
- **Per 1,000 Charge:** Some products have a per 1,000 charge that continues to be applied to the original face amount even after the face amount reduction. This reduces the efficiency of the face reduction.
- **Face Change Restrictions:** Most products have some restrictions on face changes, such as:
  - o No face amount reductions during the first X years (typically 1 year).
  - o No face amount increases after a face amount reduction.
  - o If face amount increases are allowed after face amount reductions, new underwriting is typically

40 required	104	0	0	0	1,000,000
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As with the Full Pay example, a death benefit reduction in policy year six for a 10 Pay does not result in additional premium in year six. The remaining five premiums have been reduced by 74%.

### Death Benefit Reduction Example #1: Full Pay

The following examples demonstrate how additional premiums may be required with face amount reductions.

Male, Age 65, Super Pref NS

Full Pay Funding for Lifetime Guarantee

Level Death Benefit All Years					
Year	Age	Premium	AV	SV	DB
1	65	36,700	3,965	0	2,000,000
2	66	36,700	8,068	0	2,000,000
3	67	36,700	12,419	0	2,000,000
4	68	36,700	17,030	0	2,000,000
5	69	36,700	21,919	0	2,000,000
10	74	36,700	51,137	2,049	2,000,000
20	84	36,700	0	0	2,000,000
30	94	36,700	0	0	2,000,000
40	104	36,700	0	0	2,000,000

Reduce Death Benefit Year Two					
Year	Age	Premium	AV	SV	DB
1	65	36,700	3,965	0	2,000,000
2	66	58,092	0	0	1,000,000
3	67	19,071	2,613	0	1,000,000
4	68	19,071	5,382	0	1,000,000
5	69	19,071	8,318	0	1,000,000
10	74	19,071	25,866	1,322	1,000,000
20	84	19,071	0	0	1,000,000
30	94	19,071	0	0	1,000,000
40	104	19,071	0	0	1,000,000

When reducing the death benefit in policy year two by 50%, it triggers a partial surrender charge that exceeds the shadow account value (and the account value), which results in a significant increase in year two premium to make the shadow account positive. Note the illustration does not show shadow account values. The premium is significantly reduced (-48%) after policy year two.

Reduce Death Benefit Year Six					
Year	Age	Premium	AV	SV	DB
1	65	36,700	3,965	0	2,000,000
2	66	36,700	8,069	0	2,000,000
3	67	36,700	12,420	0	2,000,000
4	68	36,700	17,032	0	2,000,000
5	69	36,700	21,921	0	2,000,000
6	70	18,663	0	0	1,000,000
10	74	18,633	9,595	0	1,000,000
20	84	18,633	0	0	1,000,000
30	94	18,633	0	0	1,000,000
40	104	18,633	0	0	1,000,000

When reducing the death benefit in policy year six by 50%, it also triggers a partial surrender charge; however, the surrender charge does not exceed the shadow account, and therefore additional premium is not required in year six. Note the account value goes to zero in year six due to the partial surrender charge, but the shadow account must still be positive in order for the death benefit coverage to remain. In this full pay example, a 50% face reduction results in a reduction in ongoing premium of approximately 50%.

## Death Benefit Reduction Example #2: 10 Pay

These examples demonstrate that heavier funded policies are less susceptible to increased premiums on face reductions.

Male, Age 65, Super Pref NS

10 Pay Funding for Lifetime Guarantee

Level Death Benefit All Years					
Year	Age	Premium	AV	SV	DB
1	65	67,335	30,794	0	2,000,000
2	66	67,335	63,671	0	2,000,000
3	67	67,335	98,388	7,086	2,000,000
4	68	67,335	135,468	50,121	2,000,000
5	69	67,335	174,634	95,388	2,000,000
10	74	67,335	408,712	359,949	2,000,000
20	84	0	69,974	69,974	2,000,000
30	94	0	0	0	2,000,000
40	104	0	0	0	2,000,000

Reduce Death Benefit Year Two					
Year	Age	Premium	AV	SV	DB
1	65	67,335	30,794	0	2,000,000
2	66	39,123	0	0	1,000,000
3	67	39,123	21,061	0	1,000,000
4	68	39,123	43,387	713	1,000,000
5	69	39,123	67,054	27,431	1,000,000
10	74	39,123	208,505	184,124	1,000,000
20	84	0	42,149	42,149	1,000,000
30	94	0	0	0	1,000,000
40	104	0	0	0	1,000,000

While a death benefit reduction in year two triggered an additional premium for the Full Pay, the higher funding from a 10 Pay provides enough cushion to cover the partial surrender charge. Therefore, an additional premium is not required in policy year two. Note the premium has been reduced by 42%.

Reduce Death Benefit Year Six					
Year	Age	Premium	AV	SV	DB
1	65	67,335	30,794	0	2,000,000
2	66	67,335	63,671	0	2,000,000
3	67	67,335	98,523	7,086	2,000,000
4	68	67,335	135,468	50,121	2,000,000
5	69	67,335	174,634	95,388	2,000,000
6	70	17,833	142,558	105,980	1,000,000
10	74	17,833	0	0	1,000,000
20	84	0	0	0	1,000,000
30	94	0	0	0	1,000,000

## For More Information

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Products with a partial surrender charge are more likely to require additional premium for a face reduction when more thinly funded (i.e., longer pay). In addition, the risk of a premium increase from a partial surrender is reduced the longer the policy has been in force, as typically surrender charges decrease over time and a cash value cushion increases over time. An X% face reduction for a longer pay, particularly a Full Pay, will result in approximately the same X% drop in remaining premiums. For short pays, an early face amount reduction will typically provide a smaller proportionate premium reduction, while a face amount reduction towards the back end of a premium schedule will result in a significantly higher proportionate premium reduction.

### Extended Term Examples

Below are examples of sustaining 100% of the original face amount in all policy years, but reducing the number of premium payments, which results in a reduced guaranteed coverage period.

Male, Age 65, Super Pref NS  
Fund for Lifetime Guarantee

Full Pay for Life		10 Pay	
Premium Duration	Lapse Age	Premium Duration	Lapse Age
Life	n/a	10 Pay	n/a
30 Pay	100	9 Pay	95
20 Pay	92	8 Pay	91
10 Pay	82	7 Pay	89
5 Pay	73	5 Pay	82
Life Expectancy*	92		92

\* Based on issue age and best nonsmoker class, using M experience

When funding at lower levels, such as a Full Pay, it may take many years before switching to extended term makes sense (i.e., where the lapse age exceeds life expectancy). In the above Full Pay example, at least 20 premium payments are required to guarantee the full face amount past life expectancy. Further, extended term for short pays may also be difficult, where the example above shows that only the 9 Pay (a reduction of only one year's premium from the original 10 year funding target) results in a guaranteed death benefit attained age that exceeds life expectancy. However, if the insured's health has deteriorated, life expectancy will be lower, and extended term may make more sense.

To successfully achieve the objective of a face amount reduction, it is essential for the client to consider product performance, restrictions, and costs, as well as alternative strategies. Inforce rejections are critical to properly evaluate the proposed face amount reduction and alternatives.

For more information, please review the attached appendix, which provides a summary of restrictions and charges associated with face amount reductions for M Carrier NLG products.

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