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# **An Assessment of No Lapse Guarantee Products and Alternatives**

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Prepared and Researched by



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No Lapse Guarantee (NLG) products continue to be very popular with clients, primarily for their low cost and guaranteed coverage. However, there is more to an NLG product than price and guarantees. It is important, for a variety of reasons detailed below, that clients and advisors are aware of the strengths, and potential challenges, of NLG offerings, and are positioned to make informed decisions about the products they consider.

This assessment includes an overview of the characteristics of NLG products, details different NLG types, and outlines strengths and weaknesses of NLG. In addition, there is a comparison of NLG versus a viable alternative, current assumption UL, and a list of critical questions to ask when considering UL versus NLG.

The following is a general overview of NLG products:

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|                                |                                                                                                                 |
|--------------------------------|-----------------------------------------------------------------------------------------------------------------|
| Primary Use?                   | Permanent need for guaranteed death benefit with cost certainty and no performance risk                         |
| Guaranteed Coverage for Life?  | Yes, if guaranteed premiums are paid on time. Can also fund to guarantee death benefit for a specified duration |
| Ability to Vary Death Benefit? | Yes, within limits                                                                                              |
| Number of Insured Lives?       | Both single life and survivorship are available                                                                 |
| Level Premiums?                | Yes                                                                                                             |
| Flexible Premiums?             | Yes (on most products)                                                                                          |
| Low Initial Premiums?          | Yes, within limits                                                                                              |
| High Early Cash Values?        | No                                                                                                              |
| Life Expectancy Cash Values?   | Typically no cash values after life expectancy                                                                  |

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## Product Description

NLG products can provide a guaranteed death benefit for life for a specified premium, even if the account value goes to zero. For other current assumption<sup>1</sup> permanent<sup>2</sup> products - such as Whole Life (WL) with dividends<sup>3</sup>, Universal Life (UL), and Variable Universal Life (VUL) - coverage terminates (lapse) when the account value goes to zero. The death benefit guarantee is subject to required premiums being paid on time. However, most NLG products allow the policy owner to make catch up premium(s) in order to fully restore the guarantee, in the event a premium payment was made after the due date.

Typically, NLG products have very high surrender charges, providing little or no cash value during the first 10 to 20 years. Most NLG products have projected cash values (based on current assumptions) that go to zero around life expectancy (attained age 80s).

Because coverage is guaranteed for life (subject to certain requirements) and there is little or no cash value, NLG can be thought of as term insurance for life.

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<sup>1</sup> Performance for current assumption products is based on current experience: mortality, interest earnings, and expenses. The assumptions are not guaranteed and may change over time as experience changes. The assumption that is changed the most frequently is the credited interest rate. As an example, if interest earnings decline by 25 basis points (0.25%), then the credited rate may also be lowered by 25 basis points. Note that there is a floor where current assumptions may not be worse than the guaranteed assumptions (e.g., the current crediting rate may not be lower than the guaranteed crediting rate of 3.0%).

<sup>2</sup> Permanent products offer coverage for life and cash values; term products offer coverage for a specified period and no cash values.

<sup>3</sup> Dividends credited in a WL product are based on current experience. Whole Life performance without dividends is guaranteed. Guaranteed WL premiums (not including dividends) are typically not competitive with NLG premiums.

## NLG Product Types

There are two different types of NLG products. The NLG product type is defined by the test used to determine if the death benefit is guaranteed (i.e., the policy stays in force even if the account value goes to zero).

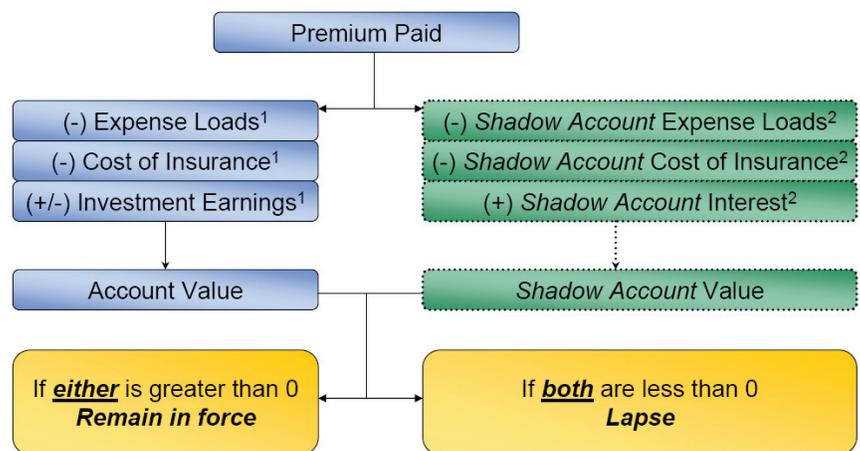
The first type (and the first NLG products to be offered) uses a *Specified Premium Test*. Coverage is guaranteed as long as the minimum premium requirement is met. The premium requirement is most commonly set by using a cumulative premium test where actual premiums paid to date must exceed the cumulative premium requirement to date; the premium requirement could also be a minimum annual premium. It is critical that NLG premiums are paid on time. Late premiums may result in the termination of guarantee coverage or a reduction in guarantee benefits (duration or amount).

Some specified premium products have a **Catch-Up provision** which allows payment of additional premium to restore the guarantee if the premium requirement had not been met. Some specified premium products include **Reset** features, which allow the guarantee duration or the amount of guaranteed coverage to be reset based on adjusted future specified premiums.

Most NLG products offered today use a *Shadow Account* mechanism to determine the guarantee. Shadow Account products offer more flexibility and provide lower guarantee premiums as compared to Specified Premium products. The death benefit is guaranteed (i.e., coverage remains in force even if the account value goes to zero) as long as the Shadow Account is positive.

The Shadow Account is an alternative account which acts very much like the account value. The Shadow Account balance is determined by the premiums paid, interest credited, and loads charged. The underlying Shadow Account assumptions (crediting rate and loads) are guaranteed, and therefore the Shadow Account crediting rate can't be lowered and the Shadow Account loads can't be increased. With a Shadow Account mechanism, flexibility is provided with regard to premium payments, duration of the guarantee, and amount of the guarantee. As an example, if actual premiums paid are less than the original premiums required to keep the Shadow Account positive for life, and the Shadow Account now goes to zero at age 95, then the death benefit is guaranteed through attained age 95. However, additional premium(s) could be paid (Catch-Up) or the death benefit could be lowered in order to re-establish the guarantee for life. Catch-up premium will include lost interest earnings. Additionally, pre funding may provide significant cost savings due to interest compounding within the Shadow Account. It is important to note that the Shadow Account is only used to determine the guarantee coverage – it can't be accessed for cash withdrawals or loan distributions.

### No Lapse Guarantee Test



1 Current assumptions are not guaranteed and may change as future experience emerges  
2 Assumptions are guaranteed

## NLG Strengths

- **Client Knows What They are Getting:** Guaranteed premium cost and guaranteed death benefit
- **Guarantees:** Death benefit and premium can be structured to be guaranteed for life. Contrast to current assumption products which are exposed to downside risk through decreased crediting rates and/or increased policy loads. Interest rates in general have been troublesome for current

assumption products, where rates have been declining for over 20 years, thereby driving down credited rates. Additional premiums have been required to keep policies on track. With NLG, you don't have to worry about changing assumptions and reduced policy performance.

- **Competitive Price:** NLG premiums are competitive with other current assumption product premium solves.
- **Easy to Understand:** It's simple - pay the required premiums on time and the death benefit coverage is guaranteed.
- **Flexibility:** Shadow Account provides flexibility in guarantee premiums (amount and timing of premiums), guarantee duration (lifetime or a duration less than lifetime), guarantee amount (amount can be reduced but still must meet definition of life insurance test, increasing coverage typically requires additional underwriting), catch-up premiums (to get the guarantee back on track), and guarantee reset (flexibility to change the guarantee premium, duration or amount of guarantee, after policy issue).

## **NLG Challenges**

- **Little or No Cash Value:** NLG products typically have heavy surrender charges for 10 to 20 years and typically run out of cash value around life expectancy. The low level of cash values relative to current assumption products offers little flexibility if the policyholder's needs change in the future (e.g., limited or no opportunity to use cash values for retirement income, collateral, short term cash, and 1035 premium for transfer to a potentially better performing product). Once an NLG contract is in place, its use is limited to serving the purpose for which it was originally purchased.
- **Liquidity Consequences:** In addition to NLG having little to no cash value, the consequences of accessing cash in a NLG product may be considered to be more negative than accessing cash in a current assumption product. Typically, accessing cash value in a NLG product via withdrawals and loans will decrease the guarantee - which defeats the original purpose of purchasing an NLG product. As an example, typically both loans and withdrawals will reduce the amount of the shadow account dollar for dollar. In addition, NLG products may have larger loan spreads (the difference between the amount charged and credited on the loan balance) than current assumption UL products.
- **Limited Upside Performance Potential:** NLG products have a limited ability to participate in favorable future experience such as higher interest earnings or mortality improvements. Since NLG provides protection from downside risk, carriers will not typically share experience gains with policyholders. Conversely, current assumption products offer the potential for improved policy performance, as experience gains are more likely to be passed through to policyholders.
- **Requirement of Timely Premium Payments:** If the required premium is not paid on time, then guarantee coverage may either be terminated or reduced (duration or amount). In cases where Catch-Up premiums are an option, the amount needed to "catch-up" will include lost interest earnings.
- **Shadow Account Complexity:** The Shadow Account is mechanically complex and may be misunderstood to be a cash value. The Shadow Account is only used to determine if full death benefit coverage remains in force - there is no cash available for distribution or loans from the Shadow Account. Additionally, the complexity of Shadow Account mechanics can make it difficult for policyholders to make fully informed decisions. For example, a policyholder that considers funding an NLG policy to guarantee coverage to age 105 may make the assumption that if he or she lives past 105, the additional amount of funding needed to extend the guarantee would be similar to the annual premium paid before age 105. The reality is that the lost interest earnings in the Shadow Account would require funding that would be many times higher than the original premium.

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- **Strings Attached to the Guarantee:** Understanding how to keep the contract in a guarantee status is critical. It is essential to read the fine print and remember that not all NLG products are alike. Examples of critical items to understand include:
  - Shadow Account or Specified Premium
  - Is there a grace period for 1035 exchanges or premium payments
  - Is there a Catch-Up provision or Reset features

For more information on what to watch out for, see the list of questions to ask about NLG below.

- **Need for Ongoing Servicing:** Ongoing servicing is required by the life insurance agent to ensure that the required premiums are paid on time or, in the event a premium was missed or late, to get the guarantee back on track. Agent compensation is typically front ended (paid during the first 10 years). This creates a situation where the compensation plan is not designed to reward long-term monitoring of policy performance, and more importantly premium administration.
- **Carrier Solvency Risk:** There is concern that NLG products are not being reserved for appropriately and are lapse supported (dependent upon normal current assumption lapse experience, while NLG lapse experience should be much lower due to little or no cash surrender value). This could lead to future carrier financial losses. To date, carrier financial strength ratings have not been materially affected by NLG business. It is recommended that only NLG products offered by highly rated carriers be considered for purchase and that solvency risk be minimized by purchasing from multiple carriers.

The following chart compares NLG versus Current Assumption.

| <b>No Lapse Guarantee Versus Current Assumption</b>               |                                                                                                                                                                                                                  |                                                                                                                                                                                                                      |
|-------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                                   | <b>No Lapse Guarantee</b>                                                                                                                                                                                        | <b>Current Assumption</b>                                                                                                                                                                                            |
| Provides a lifetime guaranteed death benefit at a guaranteed cost | <b>YES</b><br>Death benefit coverage can be guaranteed for life if the required guaranteed premium is paid on time                                                                                               | <b>NO</b><br>At funding levels similar to NLG premiums, coverage is typically guaranteed up to life expectancy (projections based on guaranteed interest credit and current loads)                                   |
| Future performance can be better than as sold illustration        | <b>NOT LIKELY</b><br>NLG premiums are most likely locked in and will not decrease based on better emerging experience <sup>4</sup> . There is minimal upside cash value potential                                | <b>YES</b><br>Better emerging experience, such as higher interest rates, higher equity market gains, or lower mortality experience, can provide lower ongoing premiums or higher cash values and death benefits      |
| Future performance can be worse than as sold illustration         | <b>NO</b><br>Guaranteed premiums and death benefit can not be worse than originally projected as long as the guaranteed premiums are paid on time; cash value performance may be worse than originally projected | <b>YES</b><br>Cash values could be lower, and additional premiums could be required to keep the policy in force if emerging experience is worse than projected (i.e., lower interest rates or equity market returns) |

<sup>4</sup> It is highly unlikely for a carrier to provide upside potential (inforce improvements due to emerging better experience) since the carrier is taking all of the downside risk.

| <b>No Lapse Guarantee Versus Current Assumption</b> |                                                                                                                                             |                                                                                                                                                                                                                            |
|-----------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                     | <b>No Lapse Guarantee</b>                                                                                                                   | <b>Current Assumption</b>                                                                                                                                                                                                  |
| Provides Cash Values                                | <b>MINIMAL</b><br>Little or no cash values due to heavy surrender charges; policy cash value typically goes to zero in the attained age 80s | <b>YES</b><br>Particularly if the policy is well funded and has a minimal surrender charge schedule                                                                                                                        |
| Low cost death benefit protection                   | <b>YES</b><br>Cost is competitive and is guaranteed; most competitive at ages 65+                                                           | <b>YES</b><br>Current cost, which is not guaranteed, may compete favorably with NLG, particularly at ages 65 and below; ultimate cost may be more or less due to changing assumptions based on changing current experience |

### **Critical Questions to Ask When Determining Whether To Purchase UL or NLG**

- Is it essential that the cost and death benefit be guaranteed for life?
  - If yes, an NLG product may offer the best fit for a client’s needs.
- Is there a potential need for access to cash values (e.g., for changing insurance needs (access to 1035 premium), retirement income, collateral, short term cash, cash for other opportunities)?
  - Cash needs typically are more common for younger insureds
  - With typically little to no cash value, NLG products may not be the most suitable for someone who may have a need for accessing future cash values.
- Consideration for upside performance potential contained in a UL product.
  - Examples:
    - If mortality continues to improve, future COIs may be reduced
    - If future portfolio yields increase, crediting rates may increase
  - Improved assumptions can provide lower ultimate premium cost or more cash value and death benefit
  - Upside performance potential is more likely for younger insureds who have a longer time horizon
- What is the cost differential?
  - To accurately assess the cost differences between NLG and current assumption UL, a thorough analysis is required. Depending on client needs, and different perspectives regarding future trends (interest rates, life expectancies, etc.), this analysis may include the following steps:
  - Compare NLG premium to UL with current assumptions
    - UL premium solve to endow at lifetime
    - UL premium solve for \$1 of cash value at lifetime
  - Determine UL crediting rate needed to provide a premium solve equal to the NLG premium
    - The current crediting rate may already provide a lower premium solve than the NLG premium
  - Run downside and upside UL illustrations to determine possible UL cost range and compare to NLG (e.g., +/- 50 to 100 bps crediting rate change)

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- Run UL paying the current assumption premium solve, but assuming guaranteed assumptions, to see how long the policy would stay inforce
  - With guaranteed charges and guaranteed crediting rate, most policies stay inforce into the attained age 70s
  - With current charges and the guaranteed crediting rate, most policies would stay inforce into the attained age 90s. This is a valid comparison since experts predict that mortality will continue to improve and because expenses/loads are rarely changed for inforce policies. In a majority of products, only the crediting rate changes over time (to reflect actual portfolio earnings).
  - UL does provide some guarantees, and many advisors and clients may be comfortable with those guarantees when quantified. As an example, a client may be happy with a partial guarantee that also provides cash value and upside performance potential.
- It may also be worthwhile considering a guarantee shorter than lifetime, like to age 100 or age 110, in order to reduce the cost by not paying for a guarantee where the probability of still being alive is very low. Then provide same comparisons as above, but where the current assumption premium solves are only to age 100 or age 110.
- Generally, when performing the cost comparisons, NLG will be more competitive at ages 65+ and UL will be more competitive at ages 65 and below.
- Also consider a variable product that provides a lifetime no lapse guarantee option.
  - Typically the variable product guarantee premiums are more expensive than NLG, but provides upside cash value potential through equity market gains.
  - Some products offer reset features where good market performance can be used to lock in lower guaranteed premiums
  - Some variable products allow for a guarantee of less than 100% of the death benefit, in order to reduce the guarantee premium cost. This allows for a partial guarantee, current performance, and upside performance potential.
  - Variable products with lifetime guarantee may have fund restrictions
  - Account value performance is typically not quite as good with a lifetime guarantee as compared to variable performance without the lifetime guarantee (i.e., there is a cost for providing the guarantee)

In many situations, NLG is an appropriate product choice, particularly for older clients who need guaranteed cost and protection. However, as detailed above, any discussion involving an NLG product must extend beyond price and guaranteed death benefit. There are a number of issues – availability of cash surrender value, flexibility, risk of losing the guarantee, lack of upside performance potential, carrier solvency – that must be considered (see Appendix A for a list of NLG Considerations).

### **For More Information**

For more information on NLG Products and alternatives, please contact a member of M Financial's Product Management Team:

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**No Lapse Guarantee Considerations**

**Sample Answers**

| <b>Premium Based or Shadow Account Based Guarantee</b>                                          | <b>Shadow Account</b>                                                                                                                                            |
|-------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Definition and Mechanics of the Guarantee</b>                                                |                                                                                                                                                                  |
| · Is the guarantee an option in the policy                                                      | No – There is a separate current performance product                                                                                                             |
| · How does timing of premium payments affect the guarantee                                      | Timing of premium payments may lengthen or shorten the guarantee period if received early or late                                                                |
| · Is there a grace period for premium payment credit to the shadow account                      | 1 Month                                                                                                                                                          |
| · Is there a grace period for 1035 premium credit to the shadow account                         | 1 Month                                                                                                                                                          |
| · Does the carrier provide advance premium notices                                              | Yes - 30 days before premium is due                                                                                                                              |
| · Can the guarantee be structured for life                                                      | Yes-depending on funding level                                                                                                                                   |
| · Are premiums flexible                                                                         | Yes                                                                                                                                                              |
| · Does the guarantee have a flexible duration                                                   | Yes                                                                                                                                                              |
| · Is the amount of guarantee flexible                                                           | Yes - within limits                                                                                                                                              |
| · Can the guarantee be less than the policy face amount                                         | No                                                                                                                                                               |
| · Is pre-funding allowed                                                                        | Yes                                                                                                                                                              |
| · Is there an interest discount for pre-funding                                                 | Yes                                                                                                                                                              |
| · Is there a catch-up (bring guarantee back on target) provision                                | Yes                                                                                                                                                              |
| · Is catch-up to the original guarantee required                                                | No - length of guarantee period will be reduced if premiums are behind schedule. Alternatively, face amount can be reduced to keep the original guarantee period |
| · Does the catch-up include interest                                                            | Yes                                                                                                                                                              |
| · Is the shadow account reduced by a policy loan                                                | Yes                                                                                                                                                              |
| · Is the shadow account reduced by withdrawals                                                  | Yes                                                                                                                                                              |
| · Is term blending an option with the guarantee                                                 | No                                                                                                                                                               |
| · What is the grace period when both the shadow account and account value equal zero            | 61 days                                                                                                                                                          |
| <b>What happens to Guarantee at Age 100 (80 CSO) or Age 120 (2001 CSO)</b>                      |                                                                                                                                                                  |
| · Do shadow account charges continue past age 100 or age 120                                    | Charges applied to age 120, then guarantee is paid up for life                                                                                                   |
| · If the shadow account is positive at age 100 or age 120, is the guarantee paid up for life    | Yes - paid up at age 120                                                                                                                                         |
| <b>What happens to Guarantee with Post Issue Changes</b>                                        |                                                                                                                                                                  |
| · What is the effect of a death benefit change on the shadow account                            | The Shadow Account will reflect the new death benefit, which may require a change to the future no lapse premiums paid to keep the original guarantee duration.  |
| · Can the guarantee be added post issue                                                         | Automatic from day 1                                                                                                                                             |
| <b>Can the Guarantee be Restored</b>                                                            |                                                                                                                                                                  |
| · Does the carrier provide a notification that the guarantee has been lost                      | Yes                                                                                                                                                              |
| · Can the shadow account be restored (make positive) if current account value greater than zero | Yes, within 60 day grace period                                                                                                                                  |
| · What is the cost to restore (make positive) the shadow account                                | Uncollected charges plus interest                                                                                                                                |
| · Can the account value be restored (make positive) when the shadow account is still positive   | Yes                                                                                                                                                              |
| · What is the cost to restore (make positive) the account value                                 | Uncollected policy loads without interest                                                                                                                        |
| · Can the guarantee be restored if both the AV and shadow account go to zero                    | No                                                                                                                                                               |
| <b>Restrictions on Availability of Guarantee</b>                                                |                                                                                                                                                                  |
| · What are the issue age restrictions                                                           | None                                                                                                                                                             |
| · What are the underwriting restrictions                                                        | None                                                                                                                                                             |
| · What are the term blend restrictions                                                          | n/a                                                                                                                                                              |
| · Maximum first year excess premium restrictions                                                | None                                                                                                                                                             |
| · Maximum total first year premium                                                              | None                                                                                                                                                             |
| <b>Current Assumption Performance</b>                                                           |                                                                                                                                                                  |
| · What is the cost of the guarantee on current assumption performance                           | n/a - There is a separate current performance product                                                                                                            |
| · At what age does the account value go to zero                                                 | Case specific - Typically attained age 80's                                                                                                                      |
| · How competitive are the early duration account values                                         | Case specific - does contain surrender charges for 20 yrs                                                                                                        |