



RISK MANAGEMENT

Life, Health, Disability, Casualty & Liability Insurance

Equity Indexed Universal Life Insurance— A Call to Action

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*"Serious problems cannot be dealt with at the
level of thinking that created them."*

—Albert Einstein

For those of us with dispute resolution, expert witness litigation support, and life insurance product suitability analysis consulting practices, Equity Indexed Universal Life Insurance (EIUL) has been a gift, albeit an unexpected and disappointing gift. Despite all the efforts that have been made over the past 30 years to eliminate "win the illustration beauty contest marketing," EIUL takes illustration abuse to new and unnecessary heights that continue to expose sales agents to reputation and litigation risks.¹

EIUL is a very attractive flexible premium nonguaranteed death benefit product that is ideally suited for investment-motivated business, estate, and wealth management planning. EIUL has become the next generation life insurance product of choice. In the first quarter of 2014 EIUL represented 39% of Universal Life sales (LIMRA). It allows the consumer to select from a menu of equity and fixed income indices for policy crediting purposes with no down market risk exposure. It allows a licensed life insurance

sales agent to sell an equity-based product without securities licensing. It allows the issuing carrier to change policy crediting features at a future date. It is ideally suited for premium finance programs because the advance rate (i.e. margin) against the policy cash accumulation account is 90% or higher versus 50% against securities. Given its design, EIUL illustrates very attractively at a time when crediting rates for universal life policies are at either a 30-year low point or the policy's guaranteed minimum.

Why suggest the need for a call to action? Given EIUL's design, what is the need to play the beauty contest game with this product? If the prospective purchaser (often an ILIT trustee who lacks life insurance product expertise) engages an unbiased fee-based advisor for a second opinion concerning the agent-illustrated outcomes, the questionable and unsupportable assumptions will be identified as discussed in this article. Is this second opinion likely? Yes, increasingly so, articles caution consumers that there is a high probability EIUL sales proposals have been based upon unrealistic crediting rates. Additionally, the National Association of Insurance Commissioners (NAIC) is in the process of adopting comprehensive new rules governing the illustrations to be used in selling EIUL,² and EIUL sales practices are under investigation by



New York State Financial Services Superintendent Benjamin Lawsky. Recognizing that a sales agent is held to a fiduciary standard, or a suitability standard at the least, why would a sales agent knowingly expose himself or herself to reputation and, possibly, litigation risk? And, if an EIUL policy has already been issued with questionable assumptions, would it not be more prudent to reillustrate an in-force policy using credible assumptions and document client communication in a dispute-defensible manner?

Let's remember that illustration credibility for flexible premium nonguaranteed death benefit products has plagued the life insurance industry for 30 years, undermined the perceived professionalism of the traditional retail distribution channel, and generated unnecessary disputes and litigation. This article does not question the very attractive design of this product. Rather, it emphasizes the need to credibly identify, communicate, and manage its risks.

As a practical matter and despite all the illustration and policy contract predictive value and policy comparison disclaimers, the "as sold" illustration remains the only numbers-oriented material provided by the sales agent to communicate that, over time, policy values should successfully achieve the buyer's planning needs. However, credible policy evaluation options do exist³ and they should be considered by agents as part of the call to action to avoid allegations of questionable, if not predatory,⁴ practices.

What to expect in this article? This article reviews EIUL's pricing, crediting, allocation, and agent disclosure issues. Further, it reviews logical investment questions utilizing traditional investment analytics and FINRA (Financial Industry Regulatory Authority) methodologies for "hypothetical illustrations of mathematical principles."

This article intentionally frames the call to action needed from a dispute resolution and litigation perspective. Every life insurance licensed sales agent reading this article should consider a "what if" scenario—if you are a party to a dispute or FINRA arbitration, how do you explain the reasonableness of the "as sold" illustration assumptions and policy contract features that allow the issuing carrier to change the policy crediting rate calculation in the future? And, how do you respond to the obvious follow-up question: What is the basis for your determination that this policy is suitable for your client's needs and serves the client's best interests?

From a fiduciary standard perspective, inattention to fiduciary issues, such as the Duties to Disclose (how the product actually works and its risk that need to be managed) and to Delegate (how the policy can be credibly designed and risk managed), is a choice. The tools are available to do the right thing in the right way in order to minimize reputation and litigation risks. By analogy, the misleading illustrations cat is out of the bag. In-force EIUL should be reillustrated at a 4.5% to 5% crediting rate assumption unless a compelling argument can be made by an investment advisor, preferably the client's investment advisor, for use of a higher crediting rate assumption.⁵ Call to action client communication is a choice or, given the NAIC and New York State Financial Services efforts, is it?

The EIUL Story

Approximately twenty years ago, attending an affluent markets study group meeting, we were introduced to Equity Indexed Universal Life (EIUL) as an alternative to Variable Universal Life (VUL) for the premium finance ILIT (Irrevocable Life Insurance Trust) marketplace.



The carrier-marketed benefit was three-fold:

- EIUL can be marketed by any life insurance licensed agent whereas VUL requires Series 6 securities licensing.
- EIUL is a declared interest rate life insurance product with a crediting rate informally tied to the S&P 500 index.
- EIUL is not subject to the 50% maximum loan to equity limitation per Regulation U (12 CFR 221.7) and, hence, allows for a significantly more favorable loan-to-policy cash value advance rate.

It was stressed that this new EIUL product was not intended to be a market-linked substitute to Variable Universal Life (VUL) if the consumer's objective is investment-motivated and the policy is not premium financed. The rationale given was: (1) an investment-motivated consumer is better served with access to 60-100 VUL fund allocation opportunities, and (2) EIUL 0% return floor does not offset the caps on positive returns and loss of Total Return participation (dividends and interest reinvested). Given this background, since the 2008-2009 financial markets crisis, EIUL has been aggressively marketed to consumers as a "no downside risk" market-driven life insurance alternative that is suitable for all financial planning and investment needs.

EIUL is one of the most, if not the most, complicated life insurance products for licensed life insurance sales agents and consumers to understand, and possibly investment advisors. Further, it requires attentive annual policy performance monitoring and risk management, but these services are not provided by either the issuing carrier or its contracted sales agent. As a result, the purchaser:

- (1) assumes performance risk for risks that may not be understood and may not be explainable by the sales agent,

- (2) is unaware of the policy evaluation capabilities needed to monitor annual policy performance, and
- (3) is unaware or uncertain of the negative policy value implications of carrier changes to the crediting process.

Couple the missing management function with this product's complexity, and you have a recipe for questionable and misleading sales practices warranting investigation.

EIUL Basics

Equity Indexed Universal Life is a declared interest rate policy, with the crediting rate informally tied to one or more market indices such as S&P 500, Heng Seng, EURO STOXX 50, etc. Like all other forms of universal life products, EIUL employs a "buy term and invest the rest" design with monthly risk charges based on the insured's age, sex, and risk class, and net-amount-at-risk (policy death benefit minus cash value).

Unlike all other Universal Life product forms, EIUL interest crediting is based on a look-back period, typically one to five years. The cash value account earns 0% or 1% until the end of the look-back period at which time the look-back crediting is based on the selected market indices, but not less than 0%. Said simplistically, if the selected market indices go up, the policy owner participates in the gains. And, if the selected market indices go down, the policy owner does not participate in losses.

But that's where the simplicity ends. For example, consider these confusing features and options:

- Fixed Strategy—an annually declared interest rate like traditional Universal Life.
- Crediting methodologies are based on the point-to-point movement of the index, not the Total Return with dividends reinvested.
- Crediting methodologies may incorporate:



- o Thresholds—Policy is credited with 100% of the excess over a 5%-6% minimum.
- o Caps—100% participation up to a maximum of 12%-14%.
- o Participation rates—60%-80% participation with no maximum.
- o Proportional crediting between multiple indices—Participation methodology taking the two best performing indices of three.
- Policy owner asset allocation between Fixed and Indexed methodologies.
- Each premium typically creates a new crediting block. If a policy premium is paid monthly utilizing 5-year methodologies, a maximum of 60 blocks are in play at any time.
- These are “use it or lose it” crediting blocks. If the policy owner needs to access cash values via surrender, withdrawal or loan, then the potential accrued Index crediting is forfeited. No other product type has this level of sophistication or “crystal ball” investment and cash management decision making.

Agent Disclosure Considerations

Since EIUL is a “declared interest” product, the agent does not have to be securities-licensed because the policy owner is not investing in an index as is the case with a variable universal life policy. When the agent is not securities-licensed and the consumer is investment-motivated, three “buyer beware” issues should be considered by the consumer. The agent:

- Cannot address the consumer’s needs because he/she does not have access to a full array of investment-linked life insurance products.
- Cannot address the consumer’s questions comparing indexed look-back methodolo-

gies and historical market performance, index fund Total Returns, etc.

- Is not governed by FINRA (Financial Industry Regulatory Association) regulations regarding communication, conduct, hypothetical illustrations, and comparative analysis. And, because the product is designed for distribution by nonsecurities licensed agents, the issuer’s disclosure materials are prohibited from providing the investment-motivated consumer with this level of expected disclosure.

A reality check is needed—is this scenario simply a “politically correct” way to deceive the consumer? The nonsecurities licensed agent can promote the 0% floor but is prohibited by states from discussing market performance, Total Return, the relationship between EIUL calculated rates and Total Return in an S&P 500 index fund or asset allocation alternatives. Hence, nonsecurities licensed agents are prohibited from disclosing or addressing common sense consumer questions.

Market Returns vs. Policy Crediting Rates

EIUL illustrations commonly use a 25- to 35-year look-back analysis as the methodology to calculate the illustrated policy crediting rate (and by implication answer the consumer’s question—“what if the policy had been available the past 25 years?”)

This calculated rate warrants three consumer questions:

- How did the S&P 500 index fund in my 401(k) compare to the EIUL rate?
- How did the return of other asset allocation strategies compare to the Indexed methodology?
- If I am assuming a 7% S&P 500 Total



Return for my long-term financial planning, what is the appropriate interest rate that should be used in this EIUL illustration?

These questions simply consider risk and return. The consumer is being asked to accept the underlying volatility/standard deviation of the S&P 500. The indexed strategy merely limits the severity of the volatility—good and bad. Said differently, is the downside protection worth the potential loss of gains?

To respond to these “common sense” consumer questions, consider the performance of an EIUL policy assuming a S&P 500 methodology, a 0% floor, 12% cap and a 25-year look-back period through 12/31/2014 to other options in Table 1.

- The 10.98% S&P 500 Index Fund return was 3.68% or 50.4% higher return than the EIUL Methodology.
- Other Allocation strategies provided comparable or greater net return than the EIUL methodology with less annual return volatility.
- The differential between the 11.25% S&P 500 Total Return and the 7.30% EIUL methodology is 3.95% or 35% less. Depending upon how the consumer wanted to factor the market return, the EIUL illustration rate should be 3.05% or 4.55% to be consistent with their other financial planning alternatives. These rates assume the consumer is using a 7% Total Return for their personal financial planning.

Hence, 7.00% less the 3.95% rate differential calculates to 3.05% or 7.00% less the 35% percentage differential calculates to 4.55%.

What if the agent is also securities licensed?

Even though EIUL is not a security, it is understood that registered reps must comply with FINRA conduct regulations in all transactions. Using the 7.30% EIUL illustration rate could violate FINRA regulations. FINRA limits gross market returns in insurance illustrations and “hypothetical illustrations of financial principles” to 10.00%. This 25-year look-back shows the 7.30% EIUL interest rate is based on an 11.25% gross market return. Utilizing the two differentials previously mentioned, the maximum EIUL illustration rate from a FINRA member is 6.05% to 6.50%.

Again, a reality check is needed. Product complexity and incomplete issuer support do not provide securities licensed reps the information to properly address investment management questions and comply with FINRA regulations.

Monte Carlo Simulations—EIUL Crediting vs. S&P 500

- Monte Carlo is an investment simulation that:
- Calculates a range of values based upon (1) a long-term average rate-of-return and (2) a defined standard deviation (volatility).

Table 1

S&P 500		Returns Net of Fund Fees or Indexed Methodology				
Total Return	Point-to-Point	S&P 500 Index Fund	EIUL Methodology	Conservative Allocation	Moderate Allocation	Growth Allocation
11.25%	8.90%	10.98%	7.30%	7.23%	7.78%	8.33%



- Is based on hundreds or thousands of trial simulations⁶ utilizing random returns within the specified standard deviation—returns do not factor investment management practices or historical experience/trends.
- Is utilized to provide a range of (1) survival periods of specified assets and expenses or (2) future values of an asset.

As an example, we considered an individual age 45 with a life expectancy of age 87 resulting in a 42-year trial period. Table 2 shows the results of a 1,000-trial simulation using both 8% and 10% rates-of-return, a S&P 500 fund standard deviation of 12.24%, a Total Return to Point-to-Point differential of 2.52%, an Index fund fee of 0.27% and a 12% EIUL cap.

The Indexed methodology results in slightly greater downside protection in the Table 2 interest trials (Column 8 vs Column 5). The loss of dividends reinvested and caps result in the Indexed methodology having significantly lower average returns (Column 7 vs Column 4) and returns in high interest trials (Column 9 vs Column 6). The Monte Carlo simulations demonstrate that the EIUL downside risk protection does not offset the lost gains. For example, EIUL illustrated 0.39% to 1.25% (Column 8 vs Column 5) greater return in the low trials,

2.16% to 3.52% (Column 7 vs Column 4) less Average return, and 7.70% to 7.84% (Column 9 vs Column 6) less High Trial returns.

EIUL Policy Costs vs. Other UL Based Alternatives

Shifting from the investment to the policy cost side of the equation, life insurance policies have four variable pricing/cost components:

- Crediting methodologies or Separate Accounts
- Surrender Charges or Surrender Refunds
- Premium Loads and Administration Fees
- General Population or HCE (Highly Compensated Employee) Class Risk Pools

As a result, there can be significant pricing differences among products offered by the same issuer for the same risk class.

For example, consider the same issuer, a male insured age 50 with a preferred nonsmoker rating, \$1 million death benefit protection, and a \$56,255 annual premium. We assume an investment-motivated design that utilizes a maximum annual premium to demonstrate the related maximum potential premium load related costs-of-insurance.

As shown in Table 3, declared interest products such as universal life and equity indexed universal life have higher initial costs than variable

Table 2

1	2	3	4	5	6	7	8	9
Specified Rate-of-Return	Average Total Return	Average Point-to-Point	Index Fund Average	Index Fund Low Trial	Index Fund High Trial	EIUL Crediting Average	EIUL Low Trial	EIUL High Trial
8.00%	7.98%	5.47%	7.71%	1.60%	15.91%	5.55%	2.85%	8.07%
10.00%	10.05%	7.51%	9.78%	2.34%	16.58%	6.26%	2.73%	8.88%



products, thus providing the issuer with an added investment hedge against its investment risk, policy crediting rate, and guaranteed minimum rate.

The underlying current mortality costs in a policy are subject to change to offset these issuer investment risks. A recent example is in-force universal life—policies with 3%-4% minimum guarantees and treasury yields at 1%-2%. As a result, issuers increase the current mortality costs on in-force policies to offset the negative spread. The same type of pricing risk is inherent in EIUL products if the issuer’s investment strategy does not outperform the policy Indexed methodology. And, if the issuer increases current mortality costs and the actual annual crediting rate is less than originally illustrated, then policy cash value is less than expected, meaning the risk of lapse is accelerated. Variable products are less susceptible to this risk as most consumers are utilizing the separate accounts (funds) and not the fixed account.

Ongoing “Good News” vs. “Bad News”

No one likes delivering “bad news” and EIUL policies position the agent in the awkward

position of delivering more “bad news” from the consumer’s perspective than “good news.”

- The loss of dividends reinvested and Indexed methodologies mean the policy is delivering lower returns than the S&P Fund in all positive markets—“bad news.” Five-year indexed methodologies generate multi-year consumer uncertainty—“bad news.”

- Only when the market is down can the agent deliver “good news”—the 0% floor.

Using the 25-year look-back as an example:

- 12% Cap—experienced 12 years (48% of this time period).
- 0% Floor—experienced 7 years (28% of this time period).
- Between 0% and 12%—the remaining 6 years (24% of this time period).

Only 28% of the time would an agent be confident of delivering “good news”—the 0% floor saved the customer from a negative return—and 72% of the time the client received less than the Total Return reported on their S&P 500 index fund.

However, what about the loss of dividends reinvested? In 2011, the EIUL policy would have

Table 3

Cumulative Costs of Insurance

Year	Corporate Variable Universal Life	Retail Variable Universal Life	Retail Equity Indexed Universal Life	Retail Equity Indexed Universal Life—GDB	Retail Universal Life
1	\$6,460	\$9,906	\$12,637	\$17,202	\$14,505
5	33,916	54,805	55,677	75,666	44,702
10	63,722	95,232	93,096	114,095	85,324
15	100,197	141,488	130,989	142,798	131,615
20	154,994	201,370	179,708	181,032	191,563



credited 0% whereas the S&P 500 Total Return was 2.11%. So there is only 24% “good news.”

This look-back also demonstrates how the underlying volatility of the S&P 500 is retained by the policyowner. This volatility pass-through results in 76% of the time the client receiving either 0% or 12%—all or nothing” relative to the 0% floor and 12% cap. By comparison, a conservative allocation during the same 25-year period generated comparable returns; however, negative returns were experienced in only three years, with positive returns experienced in twenty-two years.

Superintendent Lawsky’s Key Concerns Warranting Investigation

This investigation into EIUL sales practices is questioning if EIUL illustrations are overly optimistic. Most readers would probably agree that basing life insurance illustrations on a constant rate 11.25% average market total return is optimistic.

Additionally:

- The lack of disclosure and guidance on the relationship between market total returns and EIUL methodologies has resulted in misrepresentations in the planning value of EIUL products to other financial planning instruments.
- EIUL and the 0% crediting floor have been marketed by some agents as a way to communicate “invest with no investment loss risks.” While that may be true for the crediting rate, it does not account for the costs-of-insurance side of the equation, and other risks such as opportunity cost and purchasing power risk.
- One of the more popular sales today is using EIUL as a supplemental retirement asset for generating “tax-free” cash flows. Again, is an 11.25% average market total return realistic for this type of sale?

Lastly, should a nonsecurity product be permitted to be illustrated based upon a higher average market gross return than a security?

Suitable EIUL Planning Uses

EIUL remains a suitable product for the affluent premium finance consumer given the 50% Regulation U maximum impact that accompanies selection of a variable universal life product.

Questionable/Unsuitable Uses

On the flexible premium nonguaranteed death benefit product spectrum, EIUL is positioned between Universal Life and Variable Universal Life. If full disclosure is made to an investment-motivated consumer concerning the investment volatility, ongoing policy management risks and increased costs, arguably it would appear that a variable universal life product (retail or institutionally priced) would be a better fit.

Hence, the use of EIUL for traditional low-premium management or high-premium investment alternative planning needs is questionable and warrants a thoughtful suitability evaluation based upon credible product and policy evaluation. And, if such evaluation was not undertaken at the time of policy purchase, then it should be considered now. If this initiative is not undertaken by the agent of record, then engagement of an independent and unbiased fee-based consultant should be considered.

Suitability Letter

Whether a sales agent is held to suitability or fiduciary standard, product selection suitability must be justified. This justification should take the form of a letter generated by the sales agent that confirms the agent’s understanding of the consumer’s objectives and addresses the following points:



- Why is the agent/rep/firm qualified to serve as the writing agent for the consumer's "buy and manage" needs?
- Why is the recommended product more suitable for the consumer's planning need in comparison to other product alternatives?
- Why is the issuing carrier more suitable in comparison to other carrier alternatives?
- What are the product and performance risks that require ongoing monitoring and risk management, if any? Does the issuing carrier provide the requisite ongoing policy administration and risk management services? If not, does the agent provide these services and, if so, at what cost?
- If the requisite post-sales risk management services are not provided by the issuing carrier or sales agent, who will provide the annual policy performance monitoring and risk management services, and at what cost? If the performance monitoring is illustration-based and illustrations disclaim predictive value, why does the agent consider this scope of service credible?

As a practical matter, an investment-motivated consumer is likely aware of fund selection and management responsibilities, risk/return trade-offs, etc. EIUL is a buy-and-manage financial asset. The manage function is usually not provided by the issuing carrier and not a post-sales responsibility of the carrier's contracted sales agent. Hence, it is incumbent upon the sales agent to include this disclosure in the suitability letter and assist the consumer in obtaining the management function.

Conclusions

EIUL is a sophisticated flexible premium nonguaranteed death benefit product ideally suit-

ed for an investment-motivated consumer who understands its risks and how they can be credibly and prudently managed to maximize the probability of a favorable planning outcome. While EIUL is an attractive niche product, it is not suitable for every life insurance planning scenario. Further, it is not a simple product for agents or advisors to understand, thus complicating their client suitability recommendation and performance monitoring risk management guidance.

An increasing number of informed articles speak to these concerns and especially misleading, if not abusive, illustration practices. As mentioned early in this article, the policy evaluation tools are available for sales agents and advisors to credibly evaluate in-force policies and reassess product and/or product design suitability in the context of updated consumer goals.

Life insurance licensed agents who have sold EIUL policies are held to a fiduciary standard or a suitability standard at the least. It seems timely for agents to review their presales client marketing communication along with the as-sold illustration executed by the consumer as part of the policy delivery process, a current in-force reillustration and the policyowner's current life insurance planning objectives. Given the benefit of 20/20 hindsight and EIUL cautionary warnings, is the as-sold policy's crediting rate consistent with the rates discussed in this article? Is the policy performing as originally illustrated and, if not, why? Should credible policy evaluation be recommended to the client for annual performance monitoring and in-force policy risk management? And, finally, if this product type is no longer suitable for the consumer's objectives and risk tolerance, what restructure options should be considered and why?

If the sales agent does not maintain ongo-



ing client communication or has retired, the consumer should consider engagement of a fee-based life insurance consultant experienced with EIUL to address the above questions. If the policy is owned in an Irrevocable Life Insurance Trust (ILIT), the trustee or consumer's legal and/or tax advisors assisting the trustee in trust administration matters should recommend engagement of a fee-based consultant and obtain an unbiased review of these questions.

As a final comment, EIUL is not a “buy-and-forget” product—it is a “buy-and-manage” product and requires annual performance monitoring and risk management no different from universal life and variable universal life. It is essential to eliminate the gap between product and management sophistication, especially recognizing that the tools are readily available to do so—they just need to be used. ●

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Endnotes

- (1) This article intentionally maintains the prudent practices risk identification and management theme of E. Randolph Whitelaw's prior FSP articles, TOLI teleconference, and Lunch/Bunch program. Life insurance is a “buy-and-manage” financial asset usually purchased for a 5 to 50 year duration period, yet the issuing carrier does not offer post-sales risk management services, the sales agent does not have carrier-imposed contractual post-sales risk management servicing responsibilities, and the consumer-purchaser is rarely introduced to a fee-based third-party provider that offers “credible” policy performance monitoring and risk management services. As a result, the agent's marketing practices and suitability determinations are usually considered questionable if the policy underperforms originally illustrated values, and the reason for a lapsing policy. Hence, illustration presentation and marketing practices warrant a fresh look, especially the need for post-sales client communication and the form it should take for flexible premium nonguaranteed death benefit products given the performance risk transfer to the policy owner.
- (2) Arthur D. Postal *IUL Illustration Proposal Goes Up for Public Comment*, InsuranceNewsNet, February, 2015
- (3) FSP members have access to an HVC program and its EIUL evaluation module.
- (4) For the purpose of this article, “predatory practices” is defined as the conscious and willful inattention to, avoidance of, and disregard for known client suitability objectives, life insurance state licensing guidance, and life insurance carrier contracting guidance.
- (5) As a practical matter, multiple illustrations can be considered using different crediting rate assumptions in order to communicate a range of performance opportunity depending upon asset allocation and index selection. Arguably, some readers will consider a 5% credit rate assumption very con-



servative given the more recent equity markets performance. Whatever the differing opinions, multiple illustrations reinforce the transfer of performance risk to the purchaser, the risks to be managed and the resultant policy value expectation differences. This multiple illustration suggestion does not replace the need for delivery and execution of an "as sold" illustration. Rather, it helps to frame purchaser expectations and demonstrate agent suitability disclosure.

- (6) The Monte Carlo Simulation involves 1,000 multi-year trials that in aggregate should average the specified rate-of-return. Monte Carlo is a time-tested investment management tool to help quantify the variation of returns and outcomes based on the standard deviation of an investment strategy or fund. A low standard deviation will have trial returns very close to the mean and a high standard deviation will have a wide range of value relative to the mean.

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RISK MANAGEMENT is published four times a year by and for Risk Management Section members. This newsletter is designed to provide a forum for ideas and topics pertinent to risk management. Statements of fact or opinion are the responsibility of the authors and do not represent an opinion on the part of committee members, officers, individuals, or staff of the Society of Financial Service Professionals.

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