



INDEXED UNIVERSAL LIFE:

Mechanics and Capabilities

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The life insurance market showcases an ever-changing spectrum of products. It is common to see products come and go as market conditions change and consumer needs shift. However, every so often the market aligns perfectly to boost the market share of a specific product type. Over the past few years, we have seen rapid growth in one product type in particular: indexed universal life (IUL).

According to LIMRA's "U.S. Individual Life Insurance Sales Fourth Quarter 2011" report:

"Altogether, companies grew their IUL annualized premium by 38 percent in 2011. IUL now represents about 25 percent of UL and 10 percent of total annualized premium sales. Again, we expect IUL sales to remain strong as these products have proven to be a good fit in an uncertain economy, and companies continue to introduce products and/or enter the market." ... "The biggest stimulant behind independent agent sales (in terms of absolute dollars) was IUL, which represented 20 percent of the premium sold through free agents in 2011."¹

Also in regard to IUL, AnnuitySpecs' "Indexed Sales & Market 4th Quarter 2011" report said:

"Sales for the fourth quarter of 2011 were \$321 million, compared with sales of \$221 million for the fourth quarter of 2010. Fourth quarter indexed life sales were up nearly 28% when compared with the previous quarter, and up more than 45% as compared to the same period last year. This was another record-setting quarter for indexed life sales. This was also the fourth consecutive record-setting year for sales, beating last year's record by nearly 40%."²

This data clearly communicates that IUL is taking the life insurance market by storm. There is no better time to become familiar with the mechanics and capabilities of IUL.

What Is IUL?

When you get past all the complex terminology, IUL products are very similar to fixed universal life (UL) products, but with a different way of crediting interest. Like fixed UL, IUL offers the client the ability to customize the death benefit, length of coverage and premium obligation, and has the potential to accumulate cash value on a tax-deferred basis. With a fixed UL product, however, the cash accumulation is based on a fixed interest

rate that is credited to the policy as declared in advance by the issuing insurance company. IUL offers a fixed account option, but, in addition, it offers an index account. Performance of money allocated to the index account(s) is tied to the movement of an external market index, such as the S&P 500, or, in some cases, multiple indices.

Over time, and particularly during periods of low fixed-interest rates, because of its participation in the index market, an IUL has the potential for greater interest crediting than a fixed UL. It is important to note that IUL products simply participate in the movement of the selected index (or indexes), and do not involve the actual purchase of stocks; IUL provides indexed-linked returns.

A unique feature of IUL and a key differentiator between IUL and all other UL products is that IUL offers protection from negative returns caused by a poorly performing market or sudden market downturn. This protection is provided in the form of a minimum guaranteed interest rate commonly referred to as the “floor.” Floor rates currently range from 0–2 percent annually. Fixed UL offers generally stable and conservative crediting rates and, therefore, conservative returns. Variable universal life (VUL) premiums are invested in subaccounts that are directly linked to the stock or bond market, offering unlimited growth, but making them particularly susceptible to the ups and downs of the stock or

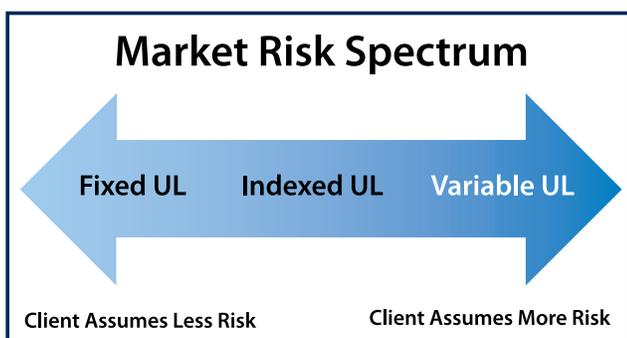


Exhibit 1

bond market. The downside protection that IUL offers helps bridge the gap between low-rate fixed UL insurance and riskier VUL insurance.

Crediting Strategies on an IUL

IULs use various crediting strategies or formulas to measure the rates of return on a selected index during a set period of time. The S&P 500 without dividends is the most commonly used index to calculate the returns of IUL products; however, insurance companies offer accounts linked to other domestic and international indices, such as the Dow Jones, NASDAQ, Hang Seng, EURO STOXX 50, Russell 2000 and others. There are also insurance companies that offer accounts with combinations of indices.

Index returns are generally calculated based on a point-to-point percentage gain in the index, but numerous other strategies exist. The most common calculation method is a one-year point-to-point strategy in which the insurance company measures the growth of the selected index over the course of a policy year. Each policy year's starting point is the previous policy year's ending point, which means that the index value is locked in at the end of the year, and the beginning value from which the movement is measured is reset. Two-year, five-year and monthly measurements are also available. When premium is allocated to a particular index account, a “segment” is created (also frequently referred to as a “bucket”) and the duration of the strategy is referred to as the “segment term.” Funds placed in the index account cannot be redirected to another strategy until the segment matures at the end of the segment term.

The credited index gain may be subject to limits referred to as the “cap rate” and “participation rate.” The cap rate is a percentage that defines the

maximum amount of interest that will be credited to an IUL policy over the segment term. Current cap rates generally range from 10–13 percent for a one-year segment term. The participation rate is a percentage that defines how much of the increase in the index’s value applies to an IUL policy. Current participation rates are generally guaranteed at 100 percent, but non-guaranteed participation rates can be higher. Most IULs have a combination of these two rates, and this combination can even vary within an IUL product, depending on the strategy selected by the client. Each segment has its own cap and participation rates, which are locked in for the segment term. Insurance companies reserve the right to reset the cap and participation rates at the beginning of a new segment but can never set them below the contractually guaranteed cap and participation rates. (See Exhibits 3, 4 and 5.)

With most insurance companies, when premiums are paid into an IUL policy, the following occurs (See Exhibit 2):

1. The insurance company will first deduct premium-based charges.
2. The premium net of charges then goes into the fixed account.
3. On a preset date, commonly referred to as the sweep date, the remaining funds that have been designated by the client to the indexed account(s) are moved accordingly, and a segment is created for each strategy to which the client allocates funds.
4. At the end of the segment term, when the segment matures, the index account is credited with interest based on index returns up to the limits set for each strategy. An index account will

never be credited anything less than the minimum guaranteed interest rate, or floor.

5. A new segment begins for each strategy based on the client’s selected allocation. The index value used for the start date of the new segment will be the same as the index value used for the previous segments end (or maturity) date. Each premium payment made by the client is handled by the insurance company as a separate segment.

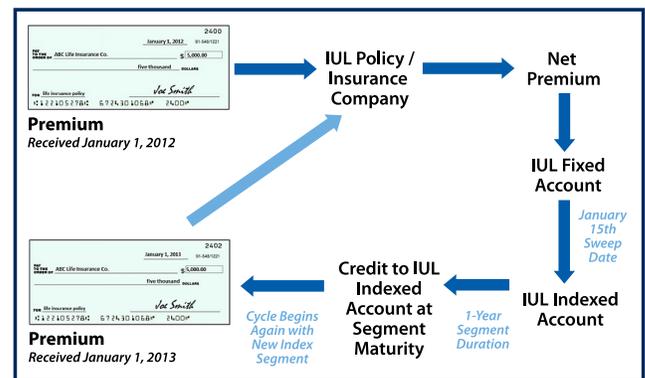


Exhibit 2: Example Premium Flow for a One-year Point-to-point Strategy with Annual Premium Mode

Cap, Participation & Floor Relationship	
Common Example #1: Index Return = 14% Par = 100% Cap = 12% Floor = 1% Policy Credit = 12% (14% return x 100% par = 14%; capped at 12%)	Common Example #2: Index Return = 8% Par = 100% Cap = 12% Floor = 1% Policy Credit = 8% (8% return x 100% par = 8%)
Down Year: Index Return = -20% Par = 100% Cap = 12% Floor = 1% Policy Credit = 1% (-20% return x 100% par = -20%; 1% guaranteed floor)	High Par Account: Index Return = 10% Par = 150% Cap = 12% Floor = 1% Policy Credit = 12% (10% return x 150% par = 15%; capped at 12%)

Exhibit 3: Examples of Cap, Participation and Floor Rate Relationship

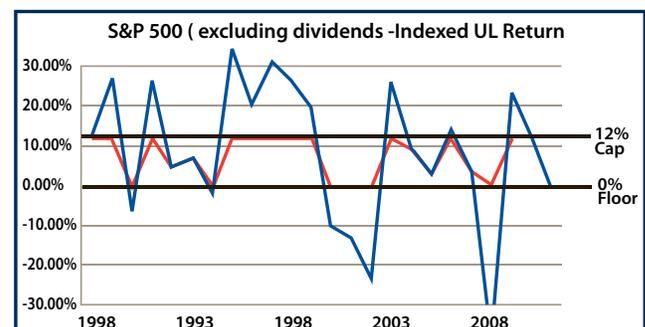


Exhibit 4: S&P 500 Returns Between 1988-2011³ and Example Impact of IUL Return

For example, a policy with annual premiums (assuming a one-year point-to-point strategy) would have one index value starting point and one credited interest rate at the end of the segment term. However, a policy with monthly premiums could have 12 different segments, meaning that it would have 12 different index value starting points and possibly 12 different credited interest rates. Additionally, two policies with similar crediting strategies but different sweep dates could have very different returns. For example, a policy with a one-year point-to-point strategy and a sweep date of Jan. 15 could have a different return, or crediting rate, than a similar policy with a one-year point-to-point strategy and a sweep date of Jan. 30; the beginning index value and end index value in each segment could be different, resulting in different crediting rates for each policy.

6. This cycle continues throughout the life of policy with the opportunity for the client to make changes in allocation percentages and selected strategies before the start of a new segment.

Year	Indexed UL Return	S&P 500 Return (excluding dividends)
2002	0.00%	-23.37%
2003	12.00%	26.38%
2004	8.99%	8.99%
2005	3.00%	3.00%
2006	12.00%	13.62%
2007	3.53%	3.53%
2008	0.00%	-38.49%
2009	12.00%	23.45%
2010	12.00%	12.78%
2011	0.00%	0.00%
Avg.	6.35%	2.99%

Exhibit 5: Example IUL Return over Past 10 Years⁴

Example index return based on a 12 percent rate, 100 percent participation rate and 0 percent floor. Assume a January 1 segment date.

Relationship to Options Pricing

Indexed UL products have a unique structure, because the interest credited is tied to the performance of an index; however, premiums are not invested directly in the stock or bond market, nor do insurance companies actually purchase stocks of companies in the index to cover the costs of crediting index returns. Insurance companies choose to hedge the index crediting risk by purchasing options from a third-party financial entity, such as an investment bank, that provides a guarantee to pay the index return in exchange for a hedge cost for the liability associated with the IUL crediting. This allows the insurance carrier to pass indexed gains along to the client without assuming the risk of a stock or bond investment.

The hedge package or options an insurance company purchases are specifically designed to match the cap rate, participation rate and floor associated with an index account. The return from the options is paid to the insurance company by the options seller (i.e., investment bank), and the insurance company then provides an index credit to the IUL policy based on these returns. By hedging the index account in a manner that replicates the participation limits and pushing market risk to a third-party financial entity, the insurance company is largely profit-neutral, as it does not lose more money if returns are below the floor, but it also does not make more profit if returns are above the cap.

The insurance company's options budget is derived from their general account yields; therefore, the most significant risk the insurance company assumes is not being able to earn enough from the general account to allow for

their options budget. This makes the price to purchase options a key element of the IUL model, as the options' cost effectively determines the participation limits within the policy and the long-term performance of the product. The insurance company will adjust participation limits based on the cost of options. If options prices rise, the carrier will have to lower the cap rate, adjust the participation rate or cover their contractual obligations from their own reserves and surplus. In most cases, this situation would result in a lowering of the cap or participation rate, resulting in decreased upside potential for the IUL policy and ultimately hindering long-term cash accumulation. This could also result in a policy lapse or additional premiums to keep the policy in force.

The same issue would arise if the insurance company's general account yields decreased without an equivalent decrease in the options' prices to hedge the participation limits the company has agreed to within the IUL policy. If, on the other hand, general account yields increased or options prices decreased, an insurance company may be able to increase the cap or participation rates. Therefore, it is important to understand that it is not solely the movement of the index (or indexes) that affects overall performance of an IUL policy; it is how well the insurance company manages its own investments

Key Elements of an IUL

There are several key aspects of IUL that agents and clients must be aware of when considering an IUL product as part of a life insurance portfolio.

Returns Do Not Include Dividends

Since the IUL premiums are not invested directly into an index, the insurance company never receives the benefit of dividends on the index. For that reason, the dividend return cannot be passed on to the client and are generally not included in the calculation of an IUL return. Additionally, the cost of options purchased on an index that reflects dividends would be more expensive, forcing carriers to lower cap or participation rates.

Discretionary Participation Limits

Most IUL policies allow the insurance carrier to change the participation limits during the life of the policy down to the contractually guaranteed minimum cap and participation rates. These changes can be made by the insurance company at the beginning of a new segment. Such guaranteed rates tend to be low, particularly the one-year guaranteed cap rate that currently ranges from 2–4 percent. The participation rate is not always as affected if the insurance company makes this change, because with most IUL policies and index strategies the participation rate is guaranteed at 100 percent. Additionally, carriers are not obligated to maintain identical participation limits between new and in-force IUL policies.

Inflated Illustrated Crediting Rates

A life insurance illustration is an integral part of the life insurance sales process, as it reflects a set of hypothetical projections depicting how a policy could perform over time, based on the design utilized and the client details (e.g., age, risk class). An important factor within an IUL illustration is the crediting rate used to project that performance. Sometimes an inflated crediting rate is used to

to create projections that are almost too good to resist from a client perspective; however, this can create unrealistic expectations, and in the majority of these cases, the policy will not ultimately perform as projected, resulting in a dissatisfied client. IUL illustrations are particularly prone to this abuse as they do not fall under any specific illustration restrictions, unlike a fixed UL, which is restricted to current rates, or a VUL, which is subject to the regulation of the Securities and Exchange Commission (SEC). It is important to consider current market conditions and the client's investment time horizon when deciding on a suitable, realistic crediting rate to illustrate.

High Policy Charges

Charges associated with any life insurance policy are also an important factor in determining the overall competitiveness of a product. These charges directly affect performance, because if a product has high charges, it may require a better return than like-kind products to offset the increased cost. Charges inside an IUL are generally higher than a fixed UL, in some cases significantly so. This indicates the possibility that, even at a conservative crediting rate, a fixed UL could potentially perform better over time than an IUL. However, some IULs are notable exceptions, and some competitive contracts offer charges similar to the charges found in a fixed UL. (See "Comparison of Fixed UL and IUL Charges") Charges with any UL policy are disclosed in the illustration, so it is important for the agent and client to review these charges to make an informed decision.

Volatility and Risk Added by Participating Loans

Many IULs offer two loan options that allow clients to borrow against the policy values: fixed loans and participating loans. Fixed loans have a fixed loan interest rate charged and a fixed crediting rate on the policy collateral backing the loan. Participating loans have a defined interest rate charge on the loan, but a crediting rate on collateral based on the performance of the index account and subject to the participation limits outlined in the policy. Many insurance companies tie their charged interest rate to the Moody's Corporate Bond Yield Average; others have a set or declared rate but reserve the right to change that charged rate at their discretion. In both cases, there is typically a maximum loan interest rate declared by the insurance company and outlined in the policy.

The advantage of a participating loan in an IUL is that the policy values that are loaned against continue to earn indexed interest. Additionally, there is the possibility that the credited earnings will outperform loan interest being charged, creating a positive arbitrage in the policy. However, a major disadvantage of a participating loan is the uncertainty and additional volatility it adds to an IUL policy. Both the policy's crediting rate and the loan interest rate can change and significantly deviate from what is originally illustrated, meaning that the total net cost of the loan is unpredictable. And, although there is the possibility of positive arbitrage, there is the possibility that the loan rate charged could exceed the policy's crediting rate, creating a negative arbitrage and causing the client to be upside-down in their life insurance policy.

Another issue surrounding participating loans has been the “abuse” of loan interest rates in some IUL illustrations that sell clients on inflated and unrealistic income distributions. Abusive illustrations project very little out-of-pocket cost for the client and outlandishly high income streams that seem to provide “free insurance.”

For most clients, a fixed loan may be a better option when accessing their policy values, as it provides stability and more predictable outcomes. However, a participating loan may be an attractive option to clients who understand and can financially tolerate the potential risks of a participating loan. Regardless of what loan option clients elect, they need to be educated on all of the implications of a loan in a life insurance policy, be shown various potential outcomes, and expect to fund the policy in a suitable manner.

Policy Monitoring

IULs are definitely not a “set it and forget it” type of product. After an IUL policy is in force, it will require frequent review from the agent and client to ensure the policy is performing as expected. It is important that an agent regularly review the statements provided by the insurance company and educate the client on what the various sections of the statement reflect. Due to the structure of the product, it is inevitable that the actual performance will not exactly replicate the original projections, and for that reason close policy monitoring is imperative.

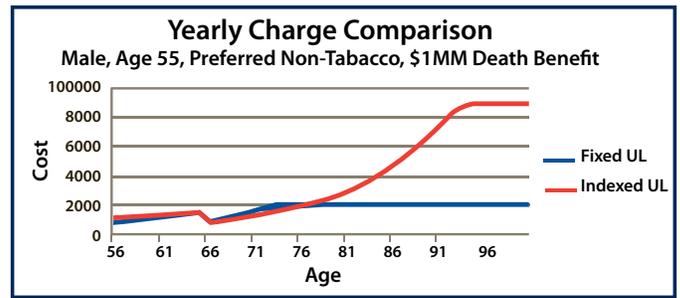
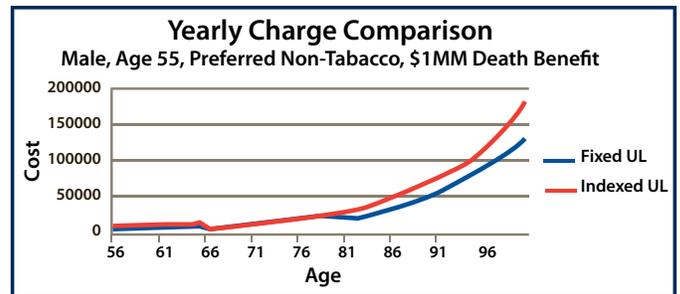


Exhibit 6: Comparison of Fixed UL and IUL Charges Example of IUL Product with High Charges in Comparison to Fixed UL

Example based on same insurance company's fixed UL and indexed UL product: male, age 55, preferred non-tobacco risk class, \$1 million death benefit, increasing death benefit (to keep net amount at risk constant), full pay, endow at maturity, both at same crediting rate of 5 percent.



Example of IUL Product with Comparable Charges to a Fixed UL

Example based on same insurance company's fixed UL and indexed UL product: male, age 55, preferred non-tobacco risk class, \$1 million death benefit, increasing death benefit (to keep net amount at risk constant), full pay, endow at maturity, both at same crediting rate of 5 percent.

Conclusion

As with all life insurance planning, it is important to establish suitability when recommending IUL to a client. IUL is not the right product for every client. Although IUL has evolved since its inception in the market and now has various sales applications based on different product designs and structures, it is still predominantly a cash-accumulation-oriented product. With an IUL, a client should expect certain levels of volatility and plan for potential changes in the projected performance of the policy. From an agent perspective, it is important to understand the client's goals related to life insurance coverage and assess their risk tolerance, investment time horizon and liquidity needs to ensure IUL is a good option. It is also the agent's responsibility as the client's insurance advisor to educate the client on the mechanics of IUL and ensure they thoroughly understand the investment they are making.

More and more insurance companies are entering the IUL market, and the growth of this product type continues to be exponential. Since this is a trending insurance topic, anyone involved with financial or insurance services should thoroughly understand this product so they can recommend it to suitable clients and be well-prepared to speak about it when the topic arises.

Sources

- ¹ LIMRA. "U.S. Individual Life Insurance Sales Fourth Quarter 2011 Report." www.limra.com.
- ² AnnuitySpecs "Indexed Sales & Market 4th Quarter 2011 Report." www.annuityspecs.com.
- ³ www.standardandpoors.com.
- ⁴ Ibid.



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Celeste Moya provides NFP Life firms with product intelligence that is unmatched in the industry. She is an excellent resource for information on individual life insurance products, including product selection, industry trends, product features, numerical comparisons and competitive analysis.