

Insurance Insights

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Unwinding the Mystery of..... *Index Universal Life Crediting Rates*

Part 3 in my series on Index Universal Life (IUL) Loan Regime Illustrations – Beware

Just a quick review of Parts #1 & #2.....Part #1 described the basic mechanics of how an Index Universal Life (IUL) policy is constructed and went into detail as to the many moving parts of the policy. The main difference between this policy and others is the crediting rate strategy on the cash value of the policy. The insurance company controls all the “levers” of an insurance policy and you just need to be aware of them and understand how the markets can impact the original assumptions.

Part #1: The moving parts and the brief comment that follow will help you gain further clarity:

1. The crediting rate will have a minimum FLOOR which is usually 0%
2. There is also a CAP on how much can be credited
 - a. It usually 10% - 13% at this stage of the product's short life span
 - b. The policy will indicate a minimum which is generally **4%**
 - c. If it becomes more expensive to hedge the return risk then the Cap will decrease
3. Costs are not guaranteed in any of the components. They do have a maximum stated in the contract.
4. Participation Rate is generally 100% of the index that the policy is basing its return on, i.e. S&P 500. Many times this rate is guaranteed but I would recommend verifying.
 - a. I have also recently seen Higher participation rates which are combined with lower Caps
5. More parts to manage = higher costs
6. Higher Cap or Floor rates = higher internal costs

In **Part #2** we discussed the actual crediting rate used in illustrations. Bottom line: Any illustrative rate greater than 6.5% is most likely too aggressive. I gave you a web site to review at www.iultranslate.com. There are so many moving parts that it is hard to understand the impact of how any one of them can impact the success of the insurance program.

Now onto to Part #3

You may run into an illustration that shows “retirement income” scenario where loans are utilized to provide tax-free income. Here again there is additional “moving part” that must meet expectations or the policy has a likelihood of lapsing generating a large imputed income which is taxable to the policyholder but with very little if any cash available to pay the ordinary income due.

This kind of illustration should raise a red flag! These kinds of programs must be monitored over a long period of time. Here is how it works. What the illustration assumes is that there will be an arbitrage between the interest rate charged and the crediting rate that the cash value earns. Generally what I see is that the interest rate charged on the loan is a fixed 6% which is quite high in relation to the current interest rate environment. The loan is fully collateralized by the cash value and they charge 6%! What actually happens is the insurance company lends you from their General Account asset base the loan amount. What *normally* happens at that point is that the insurance company sets up a loan account, transfers the loan amount into the loan account, charges an interest rate on the loan and credits back to the loan account a slightly lower crediting rate. For example, you borrow \$10,000, then set up a loan account equal to \$10,000 and charge a 5% interest rate and credit the loan account with 4% so the loan only costs 1% (if the policy is old enough they may even credit the loan account with an identical rate charged on the loan which is called a “wash loan”).

BUT here is what happens when they use what is called an Index Loan which is what is generally illustrated in these policies. They do not set up a loan account. They “leave” the loan amount in the policy to earn the crediting rate that is assumed in the illustration and charge the loan 6%. If the illustration is assuming an 8% return then in essence there exists an arbitrage of 2% that the policy cash value is earning on the loan account which is the difference between the illustrated crediting rate of 8% and the charged interest rate of 6%. This arbitrage is assumed to happen each and every year the loan is in existence. This will not happen. There will be some years it works and other years it does not. What you will see in the illustration is a cash value that continues to grow due to the arbitrage of the rate differential. The loan interest keeps piling up and if there is a poor sequence of returns when the loan is quite large you will most likely have some very real problems.

Conclusion: Beware of a tax-free retirement plan funded with loans via an IUL policy!