

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

Part 2 in my series on Index Universal Life (IUL)

In all performance based life insurance you need to be aware of what cash value crediting method is being used. This is the pre-dominant assumption that drives the calculated premium that is illustrated. Here is a brief summary of 2 of the more familiar policy types:

1. **Universal Life:** the crediting rate that is assumed in these illustrations is based on the yield of the short to intermediate term bond market. The bonds backing the crediting rate of the product are invested in the general account of the insurance company. In most policies the crediting rate can change monthly. There is a minimum guaranteed rate which the crediting rate will never below. A decrease in crediting rates has a significant impact on the long term viability of the product.
 - a. As an example; if the crediting rate drops below the assumed rate that was illustrated the policy premium will need to increase. The longer the crediting rate stays below the assumed rate, the longer one waits to correct the funding, the larger the premium commitment becomes.
 - b. Premium increases can amount to 10% to 50% of the planned premium when originally purchased.
2. **Equity-based products:** the crediting rate is whatever separate accounts the cash value is invested in but in the illustration there is assumed linear return. The volatility is much greater as there is no cap on the upside and floor on the downside. The volatility has a tremendous impact on the proper funding of the policy and therefore the long term viability of these contracts.

Now let's turn our attention to **Index Universal Life (IUL)**. Mechanically it operates just like the above. Over time you have to have enough premium and earnings to pay for the cost of insurance. It all boils down to what crediting rate you assume in the illustration which drives the funding. IUL lies "in-between" the other 2 crediting strategies. UL plays off interest rates and the other plays off the markets. IUL combines both of these strategies conservatively. Suffice it to say that the general account yield forms the base of the return while collaring the return in the option market offers the equity kicker.

I am often asked, what is the proper illustrated rate? It does and on the other hand it does not matter! The insurance companies only allow the illustration to show an assumed linear return. The only question is; how from reality will it be? How will the volatility of the return impact the policy funding? What you have done with IUL is mitigate the volatility for a price. You have "collared" the return between a Cap (10-12%) and a Floor (typically 0%).

I am not going to get into all the math of how to best estimate a return to be used in an illustration, but if you feel that over all equity returns will be 7% - 8% then this translates into about a 5.25% - 6% assumed return in the illustration in an IUL product with 10% - 12% Cap/0% floor. A great tool is www.iultranslate.com.

Most IUL illustrations will use the Hypothetical Historical Look-back Method (HHLM). This method is flawed. The return assumption is based on the fact that you purchased the policy 20 – 50 yrs. ago (depending on the carrier), the Cap never changed, option pricing never changed, and costs within the policy remained the same. The product has only been around since about the mid-90's which means that this method is purely hypothetical. We both know that general account yields will change and the pricing for the options to capture the equity exposure will fluctuate over time. The HHLM approach takes valid data and applies invalid assumptions to it. It always looks nice when you can illustrate returns 7% or greater.

Let's look at it another way:

If the insurance company's general account yield is 5 – 6% this would generate about a 5% option budget from the premium to be used to collar the return between the cap and the floor with an investment bank. If we assume a 6.5% return in the illustration this equates to a 30% return each and every year on your option budget. If the illustrated rate is 8% the option budget must produce a 60% return each year!

Conclusion: Maybe it is still a mystery but please use caution when reviewing illustrations that seem too good to be true. Realistic and conservative illustrating of crediting rates is critical for the “health” of your client's life insurance program. For IUL that means 4.5% to 6% illustrated assumptions.