

Insurance Insights

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Part 1: Unlocking the Mystery of Index Universal Life

Index Universal Life sales are increasing tremendously and account for many of my second opinions. The policy itself is not the problem. It is a legitimate form of permanent life insurance but like all performance based life insurance it must be well understood in order to gain the clarity to make an informed decision. The problem I have encountered is the illustrations and expectations of clients that are considering this type of insurance must be awakened to the realities of how it works or they will be in for quite a surprise.

Here at **The Efficient Edge**, like the police motto says, we protect and serve!

This is Part 1 of a series of articles in my attempt to help you better understand this policy structure, its basic mechanics, the risks, and how to interpret illustrations with the goal of preparing you to help your clients when asked about this policy type.

Let's begin.....

Let's review basic Current Assumption Universal Life because this is the genesis of the Index Universal Life policy structure. There are basically 3 components; expenses, mortality costs and cash value. The expenses are based on a current assumption of what the insurance company needs to charge to the policy (profit margin, recoup underwriting and policy issuance expenses, commissions, etc..) and they have the ability to change the expense assumption up to a certain guaranteed maximum at any time. The mortality cost curve built into the policy is also based on the insurance company's current assumptions about mortality and overall business profitability. They also reserve the right to increase the mortality curve cost assumptions. The cash value crediting rate is based on short to intermediate term bond rates which back the cash values. The cash values, its earnings and the premium, if paid, support the costs of the insurance policy. The crediting rate can change on a monthly basis. There is a guaranteed minimum stated in the policy and no maximum that can be credited. The consumer is responsible for funding the policy with the appropriate premium so that the earnings on the cash value plus the premium are enough to cover the costs of the policy. The annual mortality cost factor increases each year as the insured gets older. The cost factor is applied to the net amount at risk which is the death benefit minus the cash value. Therefore, in order for the policy not to lapse due to insufficient funding the net amount at risk needs to get smaller as the cost of mortality factor increases. Premiums are promulgated from the assumptions made about all the cost factors and the crediting rate. The higher the assumed crediting rate the lower the premium needed each to support the policy costs. Current Assumption Universal Life runs into problems when interest crediting rates decrease from the original assumed rate unless you increase your premium.

INDEX Universal Life is built on the same chassis with the same assumptions but it uses a different crediting strategy that is applied to the cash value. The crediting rate that will be applied to your cash value will be **based** on an Index, such as the S&P 500 Index. There are several choices typically available, in some cases as many as 12-15 choices. For simplicity, we will assume the S&P 500 index is the index of choice. The cash value is NOT actually invested in the index, you are credited the return/growth of the index EX-Dividend. The dividend return in the S&P index represents about 2% of the return which is significant over time.

But it is not that simple.....here are the parts of the “puzzle”:

1. In order to minimize volatility and manage both the risk for the consumer and the insurance company the crediting strategy has a built in minimum return called the **Floor**. The policy will have a floor or minimum return of generally 0%. The floor rate is generally guaranteed. If the index return is 0% or less then you will be credited 0% BUT there are insurance costs of approximately 3% so the actual return will be a -3%!
2. There is a maximum return called the **Cap Rate**. The Cap rate in the current environment is generally between 11% and 13.5%. If the S&P 500 grows more than the Cap rate (ex-dividend) you will not be credited more than the current Cap rate. The insurance company reserves the right to change the cap rate. Generally the guaranteed minimum Cap rate is 4% when using the S&P 500. The return that is applied is the annual return of the index from the issue date of the policy or the annual return point-to-point. The “point” is the issue date of the policy.
3. The policy also sets a **Participation Rate** in the growth/return of the index. When you choose the S&P 500 index the participation rate is generally 100%. In some policies the insurance company sets a minimum participation rate. Most of what I see is that the participation rate is guaranteed.
4. As in Current Assumption Universal Life the insurance, the company reserves the right to change the expenses and mortality cost curve.
5. **Note:** Different crediting strategies using different indices or combination of indices have different Participation Rates and Cap Rates, both minimums and maximums.

My hope is that you have noticed that the insurance company controls many “levers” of the policy structure. This can impact the long term viability of the policy if it is not set up or structured properly when implemented. The policy should be managed and monitored by anyone who implements this policy.

Let me confuse you some more.....so how does it actually work?

1. Let's assume that the NET deposit into the cash value is \$10,000 (we will exclude any up front premium tax loads which are between 5% and 7%). If the floor rate is 0% (let's also exclude any policy mortality or expense costs for illustration purposes) then the insurance company has to invest enough money in their General Account so that at the end of the year the cash value will be \$10,000 or 0% return. If the General Account of the insurance company has an overall portfolio return of 6% then then the insurance company needs to place \$94,340 into their General Account to have \$100,000 at the end of the year.
2. Now the insurance company uses a third party to hedge the risk of providing the S&P 500 return. They have \$5,660 to use for, what we call, the option budget.

3. If the S&P 500 returns 8% (ex-dividend) then the option budget must produce a 41% rate of return!
4. If the illustration assumes an 8% return then the option budget needs to return 41% per year. Actually more when you include cost estimates of the insurance, expenses, etc..
5. The option budget required return exponentially increases as the General Account Yield decreases. So if the insurance company's General Account is returning 5% then the option budget decreases to \$4,762 and needs to return 68% to reflect an 8% return in the S&P 500. If the return of the S&P 500 is 7% the option budget return must be 47%.
6. If hedging costs increase or become too volatile the Cap Rates will have to come down.
7. The higher the Cap Rate the more internal costs in the policy. So the highest Cap Rate is not the "best deal".

Index Universal Life is quite complex and the knowledge needed to assess, analyze, and implement this type of policy is quite extensive. A knowledgeable agent/broker is critical. A basic understanding of the mechanics is also critical for the buyer. My explanation above is only the beginning of the complexity! More to come! Hope you are as excited as me?!?!