Strong Equity Market, Strong IUL Sales
Easy Sale, Complex Product

Executive Summary
Sales of Indexed Universal Life (IUL) have outpaced other products for several years. Certainly recent stock market performance has made the potential cash value growth attractive.

In developing IUL, carriers attempt to marry the best features of traditional UL and VUL into a single product. By all appearances, they are succeeding, but in the process insurers have created a more dynamic and complex product, with some of its cousins’ greater risks.

In a market highlighted by otherwise flat sales growth, indexed universal life stands out with double-digit growth rates. The attractiveness to the consumer is easy to understand: equity markets have posted pre-recession highs. Literature explains that the policyowner is able to participate in this upside while being protected from the risk of loss. This downside risk protection makes the product more attractive than variable universal life (VUL), even if the crediting rate is less than 100% of returns. And this investment opportunity is wrapped in permanent insurance, usually with a no-lapse guarantee.

But from a carrier’s perspective, what is the cost of these features? We can bucket the primary risks into product, regulatory and market risks.

No IUL Standard
All IUL products are similar to traditional UL policies in that all premiums enter the policy, the cost of insurance is deducted, and the remaining cash builds value on the insurer’s general account. But this generally is where the similarity with UL ends. The crediting rate has four components:

- **Illustrated crediting rate.** Policies contain both a minimum and maximum illustrated crediting rate; these rates vary from product to product, even within the same carrier
- **Index basis.** The most common cash value credit basis is the S&P 500 equity index, but can be any equity index – or even an average of several different indices
- **Participation rate.** Policyowners “participate” in the index's posted growth at a stated percentage rate. Participation rates can be fixed or graded, and may exceed 100%
- **Crediting period basis.** While period-to-period (e.g., annual, biennial, 5-year) is most common, other methods exist (e.g., monthly average, five-year historical average, best/worst averages).
Strong Equity Market, Strong IUL Sales
Easy Sale, Complex Product (cont.)

Therefore, while the mortality component is fairly straightforward (a YRT charge, plus expenses), the cash value portion can be very complicated.

Product Risks
The popularity of the IUL product lies in its virtual elimination of downside investment risk. The insurer guarantees a minimum crediting rate, which typically is zero. (Note, however, that due to increasing YRT premium rates, the cash value may decrease in such a situation unless the policyowner increases the premium.)

Historic equity market growth, even through recessions, has trended positively, which can make illustrating potential cash value growth attractive. IUL products, however, place a ceiling on the returns possible (e.g., 10%-12%), but even these caps provide favorable longer-term growth prospects. To ensure the carrier can credit the illustrated returns to the cash value, carriers engage in a complex series of derivative investments similar to strategies that indexed annuity providers employ. (Discussion of this strategy is beyond the scope of this article.)

When sold as part of a retirement planning strategy, IUL may also contain a substantial degree of basis risk due to policyowner behavior (persistency, accumulating funds, taking loans). At this time there is no strong hedge available to manage this risk.

The end result is a much more complex product, with low lapses and high loan rates, and whose value in many cases may accrue to the policyowner only mid-to long-term.

Regulatory Risks
IUL has been popular as a retirement tool, where purchasers look to the tax-advantaged cash value accumulation as a supplement to retirement income. In such instances, IUL often comes with a no-lapse guarantee (NLG) rider. This places the product under the auspices of AG38 and its steep reserve strain. These risks have prompted more carriers to shed the NLG rider and focus more on “protection” IUL policies, where the emphasis is on the underlying mortality coverage generally sold to younger consumers.

Marketing Risks
A common caveat found with any derivative investment vehicle is: “The illustrated returns are based on historical returns and are for illustrative purposes only. Past performance does not guarantee future returns.” The first IUL policies entered the market around 1997 with many products following much later, meaning that experience is relatively limited. As a result, many companies may use policy illustrations that use historic 25-year market averages, arguing that the longer term incorporates more economic swings and therefore is more representative of potential returns.

Under a period-to-period crediting approach, companies may be determining the crediting rate somewhat frequently. This requires the carrier to update marketing illustration material often to ensure that the most recent rates are being used by their sales forces. However, the underlying factors used to determine this rate are not necessarily transparent, and depend on how the policy itself is designed.

When a high volume of marketing material is produced, risks can arise:

- Companies may create an error or omission in revising materials so frequently
- Producers may inadvertently use older, inaccurate marketing material
- Some producers may selectively use material that puts the product in the best position given current economic conditions

Equity markets are generating high returns today, so the risk of selective use of marketing material currently is low, but must be considered over the long term. Many of us recall the “vanish pay” days of early-generation VUL in the late 1980s. During this time, producers legitimately sold policies on illustrations that projected that, based on current return trends, the policy effectively would become self-funding. The resulting litigation and regulatory scrutiny is still fresh in the minds of many producers and carriers.
**Comparison of Universal Life (UL) Structures, Simplified**

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<td>Usually 0%</td>
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<td><strong>Maximum Guarantee</strong></td>
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<td>Mostly investment-grade bonds</td>
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<td>Heavy use of options and futures to manage basis risk between General Account portfolio and index performance</td>
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*IUL packages the best features of traditional UL and VUL into a single product. The result can be a complex product to manage.*

As a result, regulators and interested parties are examining closely the current language incorporated in policies for too-good-to-be-true illustrations. A pronouncement from the NAIC is anticipated by the end of the year.

**Reinsurer Involvement**

IUL features vary from company to company, and even among a single company’s products. Taking a wholesale approach to assessing and projecting product performance is therefore difficult. SCOR Global Life Americas has reviewed a number of these products where the carrier has sought coverage for the underlying mortality risk. SCOR has participated in the risk on these products on a case-by-case basis, similar to the reinsurance community at large.

**Conclusion**

IUL is the life insurance industry’s current “it” product, with appreciable sales growth. But it comes with a degree of complexity that may confuse both the purchaser and the producer trying to explain it. While IUL has become increasingly popular (last year, it accounted for 51% of traditional UL sales according to LIMRA), IUL remains challenging for even a seasoned producer to explain easily.

On the inforce management side, numerous product features involve intricacies that must be hedged with instruments whose cost to the insurer can fluctuate and which provide less than 100% protection. These complexities, combined with significant sales growth, have attracted the attention of regulators who grow concerned about potential market conduct issues.

Some carriers have the capabilities to model and develop the robust hedge programs to address some of the consumer behavior risks that accompany purchasers who are trying to maximize the cash value. Many other companies are shifting their focus to offering IUL for protection purposes, offering the value of mortality coverage with the prospect of participating in any long-term equity market gain.

SCOR has participated on the mortality risk of several client products. We continue to monitor product developments and welcome the opportunity to consult with clients about their mortality risk needs.