Indexed Universal Life: the Good, the Bad, and the Ugly

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Indexed Universal Life (IUL) has experienced rapid sales growth in recent years due to its relatively straightforward marketing story: guaranteed downside protection with upside potential. However, the oversimplification of what is, in actuality, a very complex product, has sparked growing concerns among regulators and insurance professionals as to the product's potential to mislead consumers with unrealistic earnings projections. This paper will take an in-depth look at IUL by examining the implications of the product's exemption from federal securities oversight, the way in which the product works, and the important caveats to its simplified marketing pitch.

Emergence of Indexed Products in the Insurance Industry

Before the inception of IUL, insurance companies experimented with the idea of index crediting within annuity products. In the mid-1990s, insurance companies developed the equity indexed annuity (EIA) in an effort to provide agents without securities licenses alternatives to variable products.[1] In order to offer the products as "fixed" indexed annuities, carriers had to guarantee that the products were immune to market-based losses. Thus, the product was essentially a deferred fixed annuity with a specified contract end date, designed to allow investors to participate in the appreciation of certain equity indices without actually investing in equities. The underlying investments were primarily in bonds through the carrier's general account with a small portion in derivatives. The insurance company set the various elements of the product's earnings mechanics and typically retained the contractual right to change them annually, subject to certain minimum and maximum values. [2]

By 1999, EIAs had gained popularity with consumers as growth vehicles, despite being designed primarily as target-date products. Promoters of EIAs were boasting annualized returns as high as 19.78% and industry sales were in excess of $5 billion.[3] However, in the wake of the market collapse of the early 2000s, the price of options – which are the financial derivatives used by carriers to hedge against the movement of the indices – increased, causing margins to tighten on EIAs. In order to remain profitable, insurance companies exercised their contractual rights to decrease earnings rates in existing policies, thus significantly limiting policyholders' upside earnings potential. To make the marketing story consistent with the products' performance, carriers began promoting EIAs as safe alternatives to CDs. Eventually, with little room to profit in EIAs, carriers began shifting marketing efforts to life insurance, which provided numerous ways to earn profit, including premium loads, cost of insurance, policy charges, and earnings spread.

IUL's Rise in Popularity

In 1997, Transamerica introduced the first equity indexed universal life product – the Transdex500 – with Indianapolis Life (now AVIVA) following shortly thereafter.[4] The first products featured the same crediting structure as their annuity counterparts, but credited interest to policyholders on an annual basis rather than at the end of a contract term. Consistent with today's marketing strategies, the products were positioned as hybrids between fixed and variable life and marketed to consumers desiring downside guarantees with higher upside potential than a traditional UL.

By 1999, there were seven companies in the IUL space, with American General capturing nearly a third of the total market share and Indianapolis Life aggressively marketing the product.[5] Over the next five years, sales remained

[1] FINRA.org, "Equity Indexed Annuities: A Complex Choice," *Investor Alert,* FINRA, http://www.finra.org/investors/protectyourself/investoralerts/annuitiesandinsurance/p010614
[2] Gregory Kuhlemeyer, "The Equity Indexed Annuity: An Examination of Performance and Regulatory Concerns." *Financial Services Review* 9, no. 4 (2000): 327-342.
[3] Linda Koco, "Equity Index Annuity Sales Topped $5 Billion in 1999." *National Underwriter Life & Health Magazine*, April 10, 2000.
[4] Linda Koco, "Transamerica Occidental Unveils Equity Indexed UL." *National Underwriter Life & Health Magazine*, January 6, 1997.
[5] Mike Pinkans "Equity Indexed Life." *Best's Review*, August 1, 2005.

relatively low and only three new companies entered the market. [6] However, in 2006, sales spiked to $352 million, which was nearly a six-fold increase over 1999 and an 89% increase over the prior year.[7] The rapid rise in sales was largely due to companies and agents illustrating the product with aggressive earnings assumptions.[8]

Today, IUL continues to be the most rapidly growing and heavily marketed product in the life insurance industry. In the fourth quarter of 2012 alone, sales grew 42%, which contributed to the 36% overall sales increase for the year. According to LIMRA, IUL is one of only two products that actually increased sales during the recent recession and it has had the highest annual new life premium numbers of all products over the past three years.[9]

Regulatory Oversight

Under current law, indexed products are state regulated and do not require a securities license to sell. However, the Securities and Exchange Commission (SEC) has fought since the 1990s to bring indexed products under federal securities oversight due to numerous consumer complaints and regulatory actions by state attorneys general regarding the products' reliance on the performance of equity indices and comparisons to directly owning equities.

In January 2009, the SEC approved Rule 151A, which would classify indexed products as securities beginning in January 2011.[10] The rule was very broad, which prompted several of the leading indexed annuity and indexed life providers to bring suit against the SEC in opposition.[11] While the cases were pending and before the SEC had an opportunity to tailor the rule more narrowly, the indexed annuity industry lobbied Iowa Democratic Senator. Tom Harkin of the Dodd-Frank Conference Committee in a last-minute effort to set aside the classification. On July 21, 2010, a provision now known as the Harkin Amendment was included in the "Restoring American Financial Stability Act" that reversed Rule 151A and kept regulation of indexed products primarily within the purview of the states.[12]

Despite the current federal law declaring that indexed products are not securities, the debate continues at the state level as to whether the recommendation to move client funds from securities to indexed products constitutes investment advice. Some states have adopted regulations regarding the recommendation of indexed products as substitutes for securities that can cause agents without securities licenses to lose their state insurance license if violated.[13]

The Financial Industry Regulatory Authority (FINRA), which is the self-regulatory organization that oversees all securities firms and securities licensed professionals, has also expressed concerns over inadequate disclosures of the fees and charges within indexed products. In 2012, FINRA announced that all broker-dealers must create written supervisory procedures to monitor the sales of these products by securities licensed agents. [14] Unfortunately, this rule has no force over agents who are not securities licensed and thus, provides no protection to consumers that purchase products illustrated using unrealistic earnings projections.

In order to fully appreciate the concerns over indexed products – and more specifically, indexed universal life – it is important to understand what the product is and how it functions.

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[6] Ron Panko, "A small bright star: indexed universal life insurance was the fastest-growing product line in the individual life insurance galaxy last year, and specialists expect fast growth to continue." *Best's Review,* July 1, 2007.
[7] Ibid.
[8] Ibid.
[9] Brian Anderson, "IUL and the Need for Clones in New Orleans." *LifeHealthPro.com*, April 15, 2013, http://www.lifehealthpro.com/2013/04/15/iul-and-the-need-for-clones-in-new-orleans. (Accessed May 31, 2013).
[10] Securities and Exchange Commission, *Rule 151A: Status of Indexed Annuities under the Federal Securities Law*, 2009. See, William P. Barrett, "Indexed Annuities: Protection Racket" *Forbes,* December 6, 2010. See also, Lisa Gibbs, "Index annuities are a safety trap." Money Magazine, January 17, 2011.
[11] *American Equity Investment Life Ins. Co. v. S.E.C.*, 572 F.3d. 923, 925 (D.C. Cir. 2009).
[12] Anthony Pelle and Veronica de Zayas, "SEC Rule 151A: Is the Glass Half Full (of Risk) or Half Empty?"
[13] Jeff Hanscom, "The Debate Continues: Are Indexed Annuities Securities or Insurance?" *From the States,* Bank Insurance & Securities Marketing, Spring 2011, http://www.bisanet.org/resource/resmgr/A_Singer_BISM_2011/debate_continues.html. (Accessed June 13, 2013).
[14] FINRA Regulatory Notice 12-03: Heightened Supervision of Complex Products.

What is IUL and How Does it Work?

At its core, IUL is a general account product, which means that policy values are subject to the claims of the company's creditors in the event of insolvency, and policy returns are driven largely by the returns of the carrier's general account (which consists primarily of high quality, fixed income instruments such as bonds and mortgages). However, IUL differs from most general account products in two ways: (1) the way that it credits interest to policyholders, and (2) the participation limits that it sets on a policyholder's upside potential.

Within an IUL product, policyholders have the option of allocating all or a portion of their net premiums (after policy charges) to either a fixed account or an indexed account. The fixed account functions much like traditional UL in that the interest rate credited to the policy is often the company's current stated rate (tied to the yield on their general account portfolio). The rate is subject to change but will never go below a contractually guaranteed value and is credited to the account in often indeterminate intervals. The indexed account, however, credits interest in a much more complex way. While returns are based on the performance of an underlying index or a combination of indices, the company does not actually invest in the indices, but rather gains exposure to them through options contracts purchased using some portion of the policy premium. Figure 1 shows generally how carriers determine the portion of premiums that will be used to purchase options.

Without a direct investment in the equity index, carriers possess broad discretion in determining how to credit the gain in the index to the policy. The two most common crediting methods used in IUL policies are the annual point-to-point strategy and the monthly average strategy. With an annual point-to-point strategy, the company credits interest by measuring the value of the underlying index at each policy anniversary and then calculating the growth rate. With an average monthly strategy, the company credits interest based on the monthly average performance of an index, or if multiple indices are used, a weighted blend of the monthly average performances.

Before interest is credited to the index account, it is subject to certain participation limits in the form of cap rates (which limit the degree to which the policy will enjoy the full return), and participation rates (which limit the degree to which the return is credited to the policy).[15] To illustrate how caps and participation rates work, assume that a measured index goes up by 20%. If a policy had a cap rate of 12%, only 12% would be credited to the policy. If a policy had a participation cap of 50%, only 10% would be credited to the policy. Caps and participation rates typically have a one-year lock in period and are subject to change at the carriers' discretion at each annual contract renewal. Currently, most carriers have guaranteed minimum cap rates ranging from 1-4% and participation rates around 50%, yet show non-guaranteed cap rates of around 10-14% and participation rates in excess of 100% in sales materials presented to clients.

The mechanics behind how carriers set participation limits involve numerous factors, none of which include the actual performance of the underlying index being tracked. In fact, the two biggest factors carriers consider in calculating the proper limits on a policy are market volatility and bond yields. In order for a carrier to hedge the risk that its general account will not generate a high enough return to cover the uncorrelated equity liability in its indexed account, it purchases options linked to the movement of the underlying index or indices. The budget that a carrier has to purchase options depends upon the general account yield needed to provide policyholders with the guaranteed minimum floor. For example, if the anticipated yield on the carrier's general account portfolio was 3%, the carrier would allocate 97.1% of each premium dollar received towards the purchase of bonds in their general account in order to contractually guarantee the stated floor of 0%. The remaining 2.9% would go towards purchasing packaged call option spreads from an investment bank that cover equity liability between the 0% floor and the cap (see Figure 1).

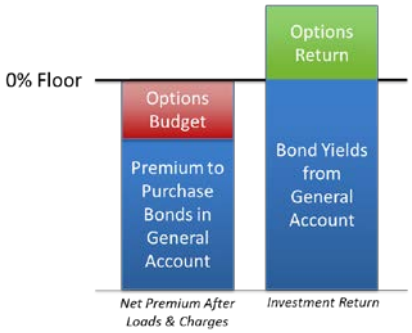

Figure 1: Allocation of premium to hedge carrier risk.

Understanding the mechanics of how carriers set cap rates is important in periods of low-interest rates and high volatility (or an extreme case of either one). When interest rates are low, bond prices rise, which in turn requires carriers to allocate a larger portion of premium dollars towards maintaining guaranteed minimum crediting rates. This

[15] Kenneth R. Samuelson, Bobby Samuelson, & Brandon W. Davis, "Do Your Homework on Indexed Universal Life" *Trust & Estates.* 2010.

leaves less money to purchase options. In addition, when market volatility increases, option prices increase. If a carrier has less money to purchase options to hedge their equity liability, they will hedge it in other ways by reducing cap and participation rates, or increasing policy charges (or some combination of both). The risk to the policyholder lies in which option, or combination of options, the carrier chooses, as well as when (and whether) it discloses those changes. Currently, only two states require carriers to receive regulatory approval prior to changing non-guaranteed elements on in-force contracts.[16]

The Absence of Dividends on Total Return

Although an IUL policy's total return may track the return of an equity index, it is important to note that its actual returns do not include dividends. Depending upon the measuring period used, dividends typically make up between 2.2% and 4.3% of total market return.

For perspective, if $1,000,000 were invested in the S&P 500 in 1989, that investment would have grown to approximately $9,219,000 today. However, if $1,000,000 were invested over the same time horizon in S&P 500 index options, which do not include dividends, the investment would have grown to only $6,061,000 – a 34% difference. (Note: example excludes tax implications of growth). See Figure 2.

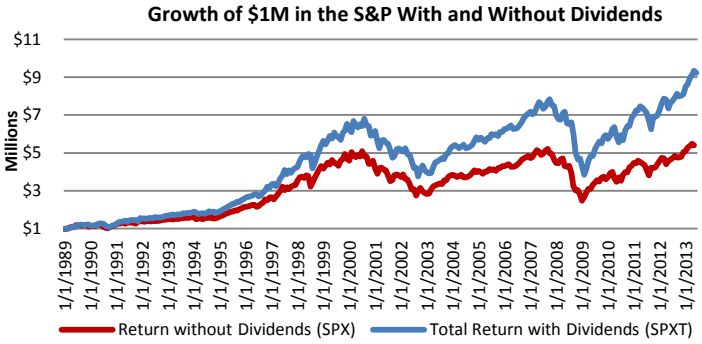

Figure 2

Without dividends to boost returns, the policyholder is effectively starting at a disadvantage, and must rely on the carrier to maintain reasonable cap and participation rates. Therefore, it is critical to understand the ways in which carriers set these rates and the effect they have on policy returns in various market conditions.

The Effect of Caps, Spreads, and Participation Rates on Policy Performance

Historical returns of the S&P 500 show that when markets are good, they are very good. Therefore, index caps on upside performance may significantly limit a portfolio's long-term performance. Over the past 83 years, the S&P 500 has closed the year with positive total returns 60 times. Of those 60 positive years, the market has returned better than 12%, in 44 of them (see Figure 3). This means that when policyholders of index products attempt to extrapolate their upside, they will be restricted to the cap over 70% of the time (assuming a constant cap rate of 12%).

To illustrate, assume that a company is able to offer a 12% cap rate consistently for the life of the contract. If this were true, a policyholder would experience 44 years of 12% crediting, 16 years of 100% market capture between 0% and 12%, and over 24 years of minimum crediting of between 0 and 2%, which would result in an average return of roughly 7.4%. Once dividends are removed, a policyholder could expect to receive around 6% *before* expenses. However, if the 12% cap were cut in half due to a sustained low interest rate environment and cyclical volatility (e.g. 2008 – today), the policyholder may actually be looking at capturing roughly a 4% return or around 2.5% after dividends are removed.

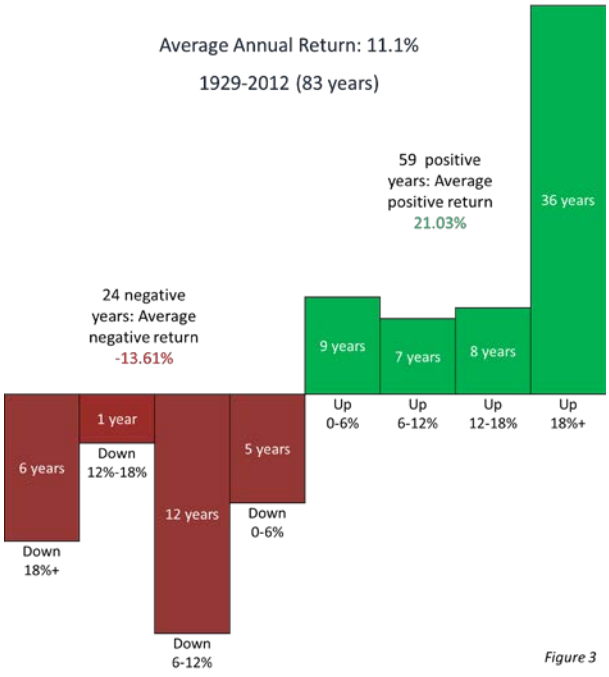

Figure 3

Bear markets have traditionally been accompanied by periods of extreme market volatility. During these times, insurance carriers go out into the market and buy options of varying durations in order to establish cap rates for the

[16] Oregon and Arkansas are the only states that require carriers to file and obtain approval of changes to non-guaranteed elements.

next 12 to 24 months, depending upon the indexing strategy used. If investors get locked into low cap rates at the end of a recession when volatility is high, they could miss out on the majority of the market gains that occur at the beginning and end of market rallies.[17] The inverse relationship between market performance and volatility suggests that caps should be lowest right before market recoveries.

Indexing has the greatest upside potential in periods of high bond yields and low volatility, as seen in the early to mid-1990s. Inversely, in periods of low bond yields and high volatility, such as today's economic environment, the potential for upside is significantly diminished. This leads to the question, why are indexed sales continuing to rise at a time of lower upside potential? The answer is likely due to the willingness of policyholders to give up some portion of their upside potential to receive downside protection. While this choice may seem logical to the average consumer, it is often predicated on false earnings assumptions created by sales illustrations that show constant rates in excess of historical market returns; making what was once an attractive possibility a less attractive probability.

Higher Charges on Most IUL Contracts

Given the considerable expense required to develop a strategic portfolio of derivatives, it is not surprising that carriers often bake higher charges into IUL contracts than they do with traditional UL products. In a study across 15 carriers comparing the cumulative policy charges per $1M of Net Amount at Risk between an IUL product and a traditional UL product the IUL policy charges were approximately 45% higher over a 45-year period.[18]

During times of sustained low interest rates and/or cyclical volatility, carriers often use increases in policy charges to subsidize higher, more attractive caps and participation rates. The degree to which these charges artificially inflate cap rates can be partially illustrated by comparing the cap rates on Indexed Annuities and IUL contracts. Cap rates for Indexed Annuities are currently averaging around 3%, whereas cap rates on IUL products are around 11-13%. The reason lies partly in the number of ways from which the carrier can profit in an IUL product. In annuities, a carrier's profitability is limited due to shorter surrender periods and fewer hidden costs. Companies make most of their margin on the spread between earnings on premiums invested and crediting rates offered to policyholders. Insurance contracts, on the other hand, have numerous sources in addition to investment spread by which to profit and recoup costs such as premium loads, policy fees, and costs of insurance charges. Figure 4 shows cap rates from the same carrier for two indexed annuity products and two indexed UL products.

Unfortunately, high projected rates in sales illustrations may mask these high charges in IUL contracts. Without proper disclosures, policyholders may unknowingly accept aggressive assumptions that could cause the policy to lapse or require the policyholder to pay a significantly higher premium to keep the policy in-force.

Indexed Annuity Caps	Indexed UL Caps
Cap Rates as of 5/2013	Cap Rates as of 6/2013
Product 1: 3.25%	Product 1: 14.00%
Product 2: 2.75%	Product 2: 11.50%

Figure 4

Expectations vs. Reality

When IUL is sold with an emphasis placed solely on accumulating cash value as opposed to contractually guaranteeing benefits, there is a high potential for unrealistic consumer expectations. Typically, illustrations focused on accumulation show the policy achieving constant high earnings rates (with a very low statistical probability of occurring), that create the illusion that the policyholder will have the choice of either paying a low premium for the policy, or generating a significant amount of cash value. Figure 5 is a matrix showing the probabilities of achieving various illustrated rates given assumed caps on returns. This data shows that the higher the illustrated rate and the lower the cap, the lower the probability of achieving that illustrated rate becomes. With cap rates currently averaging 11-13%, the probability of achieving rates higher than 7% becomes less than 60%. Few life insurance professionals would feel comfortable making recommendations that would leave almost half of their clients disappointed. In

IUL Illustrated Rate \ Cap Rate	6%	8%	10%	12%	14%	16%
4%	31%	77%	91%	99%	99%	99%
5%	0%	35%	74%	90%	99%	99%
6%	0%	0%	46%	72%	85%	94%
6.5%	0%	0%	19%	60%	82%	85%
7%	0%	0%	12%	47%	63%	82%
8%	0%	0%	0%	14%	40%	59%
9%	0%	0%	0%	0%	15%	26%
10%	0%	0%	0%	0%	0%	13%
11%	0%	0%	0%	0%	0%	0%
12%	0%	0%	0%	0%	0%	0%

Figure 5: Achievement rates based on historical S&P 500 Rolling 10 yr. Returns 1926-2012 less dividends. Source: Yahoo! Finance data.

[17] Historically, 39% of market gains have occurred within the first three months of market rallies and 28% in the last three months.
[18] Bobby Samuelson, Study parameters: Male, 55, Preferred, Costs projected through Age 100.

addition, these achievement rates assume that non-guaranteed elements such as participation limits and charges will remain unchanged throughout the contract, which is unlikely due to the considerable expense associated with the development and management of an options portfolio, as well as the carrier's broad contractual discretion to alter such elements to recoup costs.

Given the performance caveats discussed, the following are situations in which IUL can be a viable alternative for some clients, where it should be used with caution and adequate disclosures, and where it should be avoided at all costs.

The Good

Indexed Universal Life, used in the right situation at reasonable projected rates, may be a good product for some clients. In terms of cash value stability, it is likely that the cash value in an IUL contract is more stable or less subject to volatility than almost all sub-account choices of variable products. The availability of cash also adds flexibility in the timing and frequency of premium payments.

The IUL products available among companies vary widely, as does the range of benefits they provide. Some of these products provide very good guaranteed contractual benefits through riders that, if structured properly, can actually provide guaranteed benefits as good as any general account product on the market. Likewise, the cash value accumulation in some products can be good, but must be illustrated using reasonable earnings assumptions.

In order to assist advisors in choosing illustrated rates with high probabilities of success given historical market data, some carriers have developed calculators that recommend rates when variables such as caps, floors, and participation rates are entered.[19] However, while these calculators may be helpful, the rates they recommend are only as realistic as the variables used.

The Bad

Two of the primary concerns that securities regulators have with IUL are the use of unrealistic illustrated rates and lack of adequate disclosures. In the absence of securities regulation, some carriers have set high default and maximum rates in their illustration software that have allowed agents who are uneducated as to the mechanics of IUL or those promulgating abusive sales techniques, to manipulate product illustrations that mislead consumers. Furthermore, state insurance regulators are often slow to alert policyholders of contractual provisions that allow carriers the unilateral right to increase expenses and decrease caps and participation rates. Under the laws of many states, the only time these provisions are required to be disclosed is at policy delivery and the language is often ambiguous and buried deep inside the contract.

When unrealistic earnings assumptions and poor disclosures are coupled with illustrations showing income distributions through policy loans, the potential for misleading consumers increases dramatically. In today's low interest rate environment, variable rate loans tied to an index such as the Moody's Corporate Bond Index are favored over fixed rate loans, which are often higher than the prevailing market rate. Variable rate loans have been available in whole life and universal life policies for decades and have largely been considered a benefit to policyholders. However, the way in which these loans work within most fixed life policies and the way they work within IUL differs in a very important way. In a whole life or universal life policy, once the loan is processed, the carrier puts the amount of cash value pledged as collateral into a separate fixed account until the loan is repaid, during which time that cash value continues to earn interest and dividends (if applicable). In an IUL product the amount pledged as collateral is never removed from the policy's cash value, but rather it remains in the policy, is subjected to market returns and has the possibility of earning 0% in some years. This means that if the policy does not earn the illustrated rate or if interest rates increase, the policyholder may end up underwater on their loan.

For example, assume that a client takes out $200,000 from her policy 10 years in a row for a total outstanding amount of $2 million and pays 6% interest on her loan. Assume also that in the eleventh year, the stock market has a negative return and the policy earns the guaranteed floor of 0%. Despite being immune to market losses, the policyholder still has to pay 6% interest on that $2 million which would cost her $120,000 a year. If the market continued to have

[19] John Hancock's Index UL Translator: http://www.iultranslate.com/calculator.html and ING's Hypothetical Index Strategy Calculator: https://www.ingpresents.com/Calculators/HypoIndex are two examples of free IUL calculators available to both clients and agents.

meager returns, or if interest rates increased, the only money available to pay that interest charge would be the cash in the policy.

These plans are often promoted as retirement supplements. In reality, they put significant stock market risk back onto the client during distribution years which is often the exact opposite reason the client purchased the IUL in the first place.

The Ugly

While a poorly designed and poorly disclosed IUL product may perform badly for some policyholders, when it is combined with a premium finance strategy, it can produce truly ugly consequences. Premium finance involves the borrowing of funds from a bank or financial institution to pay premiums. The policy cash values (and typically other personal assets) are pledged as collateral to back the loan. The sales materials created by the marketing organizations promoting this concept tie a relatively high, constant illustrated rate to low projected borrowing costs for the life of the loan, which creates the appearance of "free" insurance. However, in reality, these are generally full-recourse loans, which means that if this plan does not work, the client is personally liable for the difference.

The spreadsheets created by the companies promoting this concept almost always show a projected arbitrage between the borrowing rate and the illustrated crediting rate in the policy. After a certain amount of time, the projected cash values exceed the loan and accumulated interest and it appears as though the more money the policyholder borrows, the more they make. The fallacy of these projections is that they assume constant crediting rates that are unlikely to materialize for the reasons previously stated, and consistently low rates of borrowing which are usually subject to requalification and rate adjustment at some point during the life of the loan. If these sales proposals are stress tested for both lower crediting rates and increased interest costs of borrowing, the results prove that there is no such thing as a free lunch. In fact, in the end, "free" insurance often ends up costing the client not only their personal assets that were pledged as collateral, but attorney's fees and time spent in litigation attempting to reclaim those assets.

Summary

Life insurance contracts are highly complex financial products that span a long period of time. True insurance professionals take the time to help clients understand the positives and negatives to the products they recommend. Indexed Universal Life offers certain benefits to consumers; however, even the purported benefits are prone to disappoint if they are not clearly understood. Because IUL is a general account product, informed policyholders should understand these contracts are unlikely to produce long-term returns in excess of bonds, given the restrictions on the investments in the company's general account, the interest rate environment, and market volatility. Furthermore, they should be aware of the wide discretion carriers possess in determining how to credit interest to policies.

The application of this product ranges from a very low risk offering that may be appropriate for many clients to a very speculative offering that has high risk of loss. Therefore, suitability should be determined on a case-by-case basis after a careful examination of the facts and circumstances surrounding the transaction. Factors to be considered when assessing suitability include:

- **Whether the client is relying completely on guarantees offered in the contract.**
- **Whether the guaranteed premiums and death benefits are competitive with other general account or separate account offerings.**
- **Whether the projected cash value is being relied upon to either support a death benefit that is not guaranteed, or as a basis for making cash withdrawals or loans in the future.** These sales should only be to sophisticated clients after full disclosure of all material risks and examination of alternative earnings scenarios.
- **Whether the sale involves premium financing of any sort.** All premium financing structures should be avoided as they fall outside the risk of responsible life insurance sales by subjecting clients to significant loans that are often backed by the client's personal assets as collateral. The chance of a positive outcome for the client is significantly outweighed by the risk assumed and the likelihood that the client does not fully understand the product and the consequences of underperformance.

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