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## Do Your Homework on Indexed Universal Life Insurance

Answer four key questions before combining this product with premium financing for your high-net-worth clients

The world of life insurance presents what feels like a never-ending array of products and choices. One of these emerging product structures, indexed universal life insurance (indexed UL), may be heavily marketed to your high-net-worth clients. Typically illustrated at rates higher than traditional policies, these indexed UL products appear to offer an opportunity to manage risk.

The value proposition seems simple, but proceed with caution: The mechanics of this product are complex and often not clearly articulated by those promoting this product structure. To help you determine whether to recommend indexed UL for your client, let's look at how indexed UL works, learn why it's important to carefully evaluate the sales illustrations promoting the product, evaluate the efficacy of combining it with premium financing and suggest questions for you as an advisor to high-net-worth clients to ask along the way.

### How it Works

Indexed UL is much like traditional UL in its basic structure. The fundamental difference is how interest gets credited to the policy. Traditional UL has a stated interest crediting rate that's based on the insurance company's underlying pool of assets, primarily bonds, which support the product.

Equity indexed products, on the other hand, credit returns in a very different way. Policy earnings are based on the performance of an equity index like the S&P 500. The policy is structured to have upside potential based on the performance of the market, while maintaining a guaranteed downside protection of a minimum 0 to 2 percent return, which is set by the insurance company offering the contract. Indexed products offer what appears to be a desirable combination of upside potential with limited risk, all in a universal life structure.

The S&P 500 is the most common equity index used to calculate market upside in indexed UL products, although some carriers offer accounts linked to other international and domestic indices or combinations of indices. The insurance carriers don't actually purchase the indices, but credit performance to the policy based on the purchase of options linked to the relevant index.

Since indexed UL products don't actually invest premium dollars in the index, carriers have broad discretion in determining the methodology for crediting the gain in the index to the policy. The most common and intuitive method, known as the "annual point-to-point strategy," is to calculate the gain from the point the premium enters the indexed account to exactly one year afterwards. Carriers may offer several other ways to calculate and credit the gain.

### Participation Limits

Indexed UL products limit the degree to which the policy will enjoy the gain (that is, the maximum possible annual return) in the index; this is expressed as a "cap rate." (See "How to Credit Returns," p. 2.) The product may also limit the degree to which the return is credited

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to the policy; this is called the “participation rate.” A participation rate determines the percentage of the total index gain transferred to the policy values. These two limits are jointly referred to as “participation limits.” Each indexed UL product has a unique combination of these two elements.

But take note: **When evaluating indexed UL products, read the fine print. Many indexed UL products often contain caveats that can have a wide range of significance to the policy owner.** For example, virtually all policies allow the insurance carrier to change

Indexed UL contracts require better return performance than their traditional UL counterparts to offset the increased cost structure.

cap rates and participation rates at any time during the life of the policy. Carriers even have the right to change participation limits down to guaranteed minimums stated in the contract, typically so low that the expected credits would be less than Treasury yields. Additionally, insurance carriers aren’t obligated to maintain consistent participation limits between new policies and in-force policies.

**One of the most significant details often overlooked is that indexed UL products don’t account for dividends from the underlying index.** Remember, the carrier doesn’t purchase the index, but rather an option associated with the index. This means that dividends aren’t included in the return calculations, which could be a significant reduction of performance when compared to the index with reinvested dividends.

### Policy Charges/Illustration Rates

There are several issues associated with indexed UL insurance that could affect whether it makes sense for your client to purchase it. Let’s look at two of these components—policy charges and illustrated rates.

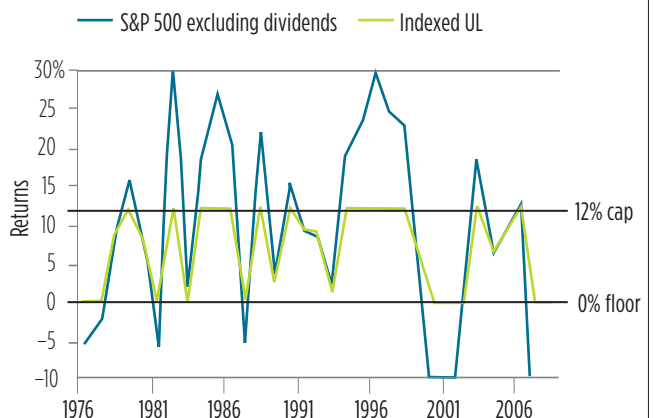
- **Policy charges.** Policy charges are as important as policy credits in the performance of life insurance contracts. When making a comparison of indexed

UL charge structures, traditional UL products are the best benchmark for determining reasonable policy expenses. With some notable exceptions, mortality charges inside indexed UL products are, on average, meaningfully higher than traditional UL products. Consequently, indexed UL contracts require better return performance than their traditional UL counterparts to offset the increased cost structure.

- **Illustrated rates.** Life insurance illustrations are a central part of the life insurance sales process. They illustrate the possible future performance of the life insurance product based on a wide variety of assumptions, the most prominent of which is the assumed credited interest rate. Unfortunately, life insurance marketing often turns into an unproductive exercise of illustrating higher and higher hypothetical rates. Indexed UL products are particularly prone to excessive focus on illustrated values because the products don’t fall under the specific illustration restrictions of variable UL or traditional UL. Thus, carriers have significant leeway concerning

### How to Credit Returns

*Indexed UL often bases its performance on the S&P 500 and limits the degree to which a policy enjoys gain*



— Bobby Samuelson, SamuelsonDesign, LLC

illustrated rates in indexed UL, whereas variable UL is a registered product and traditional UL is restricted to projecting at currently stated rates.

Carriers typically illustrate future product performance based on some method of observing historical performance of the subject index. The challenge is that indexed UL products haven't been around long enough to use actual historical indexed UL performance. As a proxy, carriers estimate historical returns by applying their current, non-guaranteed cap and participation rates to historical index data. Illustrated rates using this type of analysis generally range from 7 to 10 percent, which is higher than traditional UL products in the current interest environment of 2010.

### Dissimilar Comparisons

Indexed UL products are actively marketed as an alternative to traditional UL products. These traditional products illustrate at a rate comparable to highly rated corporate bonds of, say 4 to 5 percent. Insurance carriers

Comparison of indexed UL to traditional UL based on hypothetical analysis creates an environment for misinterpretation.

and promoters point to the indexed UL illustrated rates gleaned from hypothetical historical back-testing to substantiate a consistent performance advantage over traditional UL of 200 to 500 basis points or 2 to 5 percent.

But the two illustrated rates, however, aren't readily comparable. Indexed UL rates are based on hypothetical historical performance with analysis covering past economic environments, often 20 to 50 years, during time periods with significantly higher risk-free interest rates. Traditional UL illustrations are limited to the current yield offered in the product, based on a carrier's current general account assets. Carriers are, in effect, using historical index returns to show a performance advantage for indexed UL over current rates in traditional UL products. Again, these aren't comparable.

To compound the problem, carriers make no adjust-

ment for the impact different interest rate environments may have had on caps and participation rates over time.

A 12 percent cap may be competitive in today's interest environment when Treasury rates are at 2 percent, but it would be uncompetitive in the 14 percent rate environment of the early 1980s. Comparison of indexed UL to traditional UL based on hypothetical historical analysis creates an environment for misinterpretation.

### Hedging Risk

Insurance products are, at their core, financial instruments. Indexed UL products have a unique structure because the carrier has promised upside exposure to an equity index that's largely uncorrelated to its own general account yield. The carrier can either retain the liability associated with this promise on its own books or purchase insurance in the form of options to cover the cost of this added benefit to the policy.

Most carriers choose to hedge the risk and purchase options to remove the liability from their books. This limits the equity exposure to the carrier's bond-based general account. This liability removal transaction forms the foundation for indexed UL pricing. The price to purchase these options determines participation limits, carrier profitability and long-term product performance.

This means that the carrier pushes market risk inherent in the product to a third-party option seller and thus is largely profit-neutral to the actual performance of the index. Annual profit and loss on the policy from the carrier's point of view is determined by the relationship of options prices to the options budget, which is derived from general account yields.

Suppose a carrier markets a 12 percent cap and a 0 percent floor but must pay more for the options than the general account yields justify. The carrier has three choices: (1) lower the interest cap rate; (2) change the participation rate; or (3) financially subsidize the product from elsewhere in the company. The carrier faces the same decision if general account yields decrease without a corresponding decrease in options prices for the cap and participation rates it's promoting.

The primary implication for future performance of the policy is that all equity-like upside from the product must come from options returns. Since the vast majority of the policy values are dedicated to maintaining reserves for the guaranteed minimum floor, the relatively small premium used for the options budget is the only piece that has the opportunity to earn interest

**above and beyond the guaranteed minimum floor.**

Let's look at a typical indexed UL hedging transaction from start to finish. In "Hedging Risk," this page, assume a \$100,000 net premium payment after premium loads and policy charges. At the beginning of the year, the carrier sets a guaranteed floor, assumed to be 0 percent, and sets a general account rate (5 percent in this example). At the 5 percent rate, the required premium of \$95,238 will grow to the net premium of \$100,000 by the end of the year, thus achieving the 0 percent guaranteed floor. The residual premium, \$4,762, is used to purchase options to hedge the indexed liability. The options returns dictate any excess policy yield above the guaranteed rate floor.

"What Goes Where," p. 5, depicts the flow of money and interactions between investment costs inside of a typical indexed UL product:

- Step 1: The writing carrier makes a published statement about participation limits inside of the indexed UL policy.
- Step 2: The client pays a premium into the product and loads and policy charges are deducted.
- Step 3: The net premium goes to the carrier's general account.

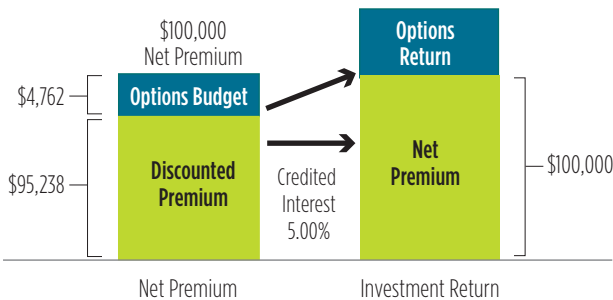
- Step 4: The general account yield dictates the amount of premium required to satisfy the guaranteed floor.
- Step 5: The residual amount, also determined by the general account yield, goes to an investment bank to purchase options that exactly replicate the participation limits inside of the policy.

Anyone considering a financed life insurance transaction should be aware of certain important disclosures.

- Step 6: The investment bank writes the options and effectively provides insurance coverage for the liability associated with the indexed UL crediting rate.
- Step 7: The carrier provides an index credit using the returns from the options.
- Step 8: The carrier adjusts participation limits based on the cost of options as it relates to the general account yield. The options budget must match the cost of options for a stated participation rate for the carrier to be profit neutral in the transaction. Step 1 starts again with newly stated participation rates if needed.

**Hedging Risk**

*The residual premium is used to buy options to cover the cost of promised upside exposure—this removes liability from a carrier's books*



— Bobby Samuelson, SamuelsonDesign, LLC

It's reasonable to assume that indexed UL products could outperform their traditional UL counterparts. In a 5 percent interest environment—and holding everything else constant—to achieve approximately 25 to 50 basis points on average over the long term would require a return on the options in the 10 to 15 percent range per year. (See "Return Patterns," p. 6.) An 8 percent projected yield on an indexed UL product in a prevailing 5 percent interest rate environment would require a much higher yield, somewhere in the neighborhood of 60 percent. This type of return pattern is challenging in virtually any economic climate and puts significant pressure on the carriers to deliver the elevated returns typically illustrated in indexed UL products.

### Premium Financing

Premium financing is the use of third-party capital to purchase insurance. For high-net-worth estate planning, premium financing typically entails accessing a lending institution to pay life insurance premiums. Traditional life insurance premium financing uses a fully-collateralized note typically structured as a floating or fixed rate based over the London Interbank Offered Rate. Other types of more exotic premium financing are available but have become less common with the recent upheaval in the credit markets.

Just as illustrations are an integral part of the life insurance sales process, spreadsheet analysis is equally important to premium financing. Promoters use assumption-driven spreadsheets to project the potential outcome of a transaction. While this is a useful practice to present one possible result of a transaction, they're rarely sophisticated enough to accurately depict the wide range of possible outcomes.

Promoters often overstate policy returns and understate interest rate risk by illustrating assumptions that reflect favorably on the transaction. They often stop short of analyzing the probabilities of the assumptions actually coming to fruition. As with any leveraged transaction, small variations from expectations can compound into large differences over time.

To make an informed decision, anyone considering a financed life insurance transaction should be aware of certain important disclosures. First, premium financing is subject to the lender's collateral and financial underwriting requirements. Premium financing borrowers are required to undergo financial scrutiny from the lender, pledge collateral in addition to the policy itself and, in most cases, there's a risk of the lender calling in the loan. Second, premium financing is complex and involves many risks, such as the possibility of policy lapse, loss of collateral, interest rate and market uncertainty and failure to re-qualify with the lender to keep the financing in place and maintain the desired level of insurance protection. Third, financing lenders typically require additional collateral during the early years of a policy

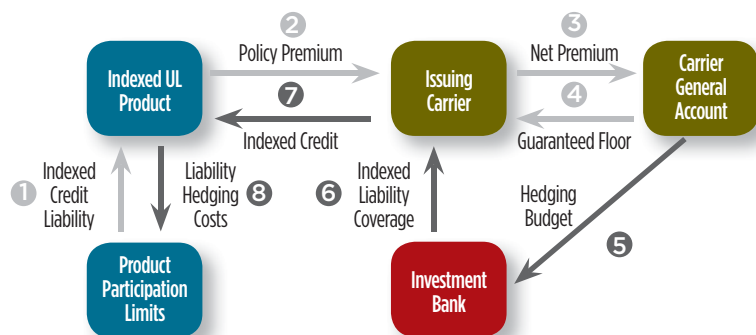
in the form of cash, cash equivalents, marketable securities, a personal guaranty or a letter of credit from a bank approved by the lender. Interests in closely held businesses and real estate aren't generally acceptable collateral. And finally, in certain situations, additional out-of-pocket contributions may be required to retire the debt and/or maintain the desired level of insurance protection.

### The Combo

What happens when you mix indexed UL and premium financing? Today, indexed UL is promoted in the marketplace as a viable structure for premium financing. Its

### What Goes Where

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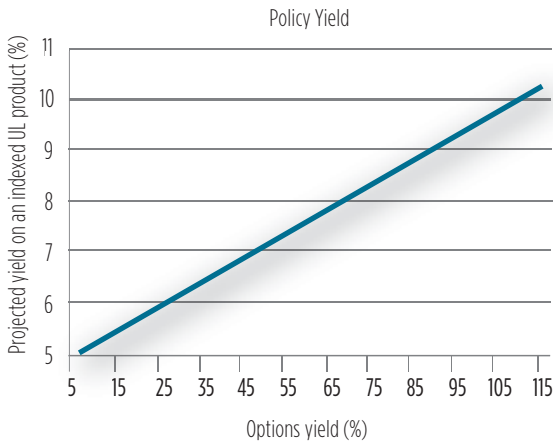
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high-illustrated rate produces what seems like a successful spreadsheet analysis. Financed indexed UL shows more long-term arbitrage, or positive spread between policy performance and financing costs, than would be possible using a traditional UL illustration. As such, promoters have eagerly embraced premium financing of indexed UL products despite the fact that the mechanics behind it are largely the same as with traditional UL.

Typically, premium financing with indexed UL deviates from traditional UL when presented in a spreadsheet to the client. Indexed UL products are typically illustrated at a rate well above 7 percent, which assumes a 1.5 percent-plus long-term performance advantage

### Return Patterns

Higher projected yields on an indexed UL product in a 5 percent interest environment require higher options yields



— Bobby Samuelson, SamuelsonDesign, LLC

over traditional UL. In today’s interest rate environment, loan rates are typically illustrated at between 2 and 5.5 percent for the life of the arrangement.

Disregarding policy charges, promoters point to the difference between the indexed UL hypothetical crediting rate and the arbitrarily projected future loan interest rate as a possible “sustainable arbitrage” (that is, the ongoing positive spread between cost and performance). Based on the theory of sustainable arbitrage, the client can essentially acquire large amounts of life insurance while paying little or no costs out-of-pocket.

According to the financial spreadsheet, loans often pay the entire policy premium and incorporate all loan interest and loan origination costs. Clients may be shown an additional collateral commitment for the first few years of the loan, but interest rate arbitrage based on illustrated index yields is often shown to quickly build cash values sufficient to offset the loan balance and related collateral requirements. Unlike most traditional UL premium financing arrangements, the financed indexed UL spreadsheet often doesn’t show a need for any repayment of debt aside from the policy death benefit at maturity.

Not all indexed UL and premium financing illustrations are this extreme. Some promoters recommend, and

some lenders require, that clients pay loan interest annually to limit debt exposure. Some promoters guide the client to work with attorneys or advisors to implement estate-planning vehicles that develop a source of repayment for the external financing. These methodologies are very helpful in reducing the risks of the structure.

### Bottom Line

Before you recommend financed indexed UL insurance for your client, we recommend that you ask the following questions:

1. Does this strategy work if the indexed UL policy is illustrated at a crediting rate similar to a traditional UL?
2. What rationale was used to determine an acceptable illustrated loan interest rate?
3. Does the carrier have different cap and participation rates for new business and in-force policies? If so, why?
4. When illustrated at the same crediting rate as the traditional UL product offered by the same carrier, does this product perform better or worse? If worse, what are the additional policy expenses in the indexed UL product that aren’t present in the traditional UL?

As you can see, financed indexed UL insurance is a complex transaction, to say the least. A spreadsheet analysis of premium financing and indexed UL shows one of an infinite number of possible outcomes. The structures that have the highest possibility of manifesting a positive outcome will be based on conservative illustrations and assumptions as they relate to both the product as well as the financing structures. These structures are too new to judge whether they are a good or poor idea. Advisors need to be informed about the nature of the indexed UL insurance structures as well as the specifics of the financing to make a wise recommendation to clients. **TE**

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