Index Universal Life (IUL) Caps: Will They Rise When Interest Rates Rise?

Introduction

When talking to advisors and agents, questions arise about the performance of IUL products. Foremost concerns are about current cap levels, primarily their sustainability (the cap defines the upper limit of the policy cash value crediting rate).

Data shows that over the last 5 years IUL caps have gradually fallen, leading some to wonder what would stop carriers from gradually dropping caps to the policy's minimum guarantees. This concern is particularly common when the client is considering whole life as an alternative because whole life discussions begin with guaranteed performance enhanced by dividends. Legally this is possible, and advisors may need some clarity to make a decision.

So, how valid and relevant is the concern that caps may fall to the level of policy guarantees?

Driver of Caps

In an earlier white paper, *IUL Setting the Record Straight* (see WWW.NIWCORP.com) it was shown that the primary driver of IUL caps is the insurance company's general account return (declared rate or fixed income return). In other words, cap levels are essentially driven by the amount of money the carrier has available to purchase long options in support of its IUL book of business. While option pricing is a combined function of option budget, market volatility, and the price of zero-risk products, data indicates it is the option budget that is by far the overriding driver. This is particularly true when considered over the medium to long term.

It's indisputable that the reason whole life dividends, universal life declared rates, and IUL caps have fallen over the last 20 years is the declining interest rate environment. As rates fall, the general account return must also fall because its portfolio is comprised of primarily fixed income investments. When rates rise, bond returns in the general account will increase slowly as the life insurance carrier replaces maturing bonds and adds additional bonds with new premium. The question is this: will the carrier keep the extra return instead of passing it on to the end client in the form of higher caps, dividends, or declared rates?

The life insurance carrier would say that they take their profit in the form of money management fees, costs of insurance, and policy charges; thus regarding the improved yields as policy owner money. On the other hand, cynics would disagree and say the life insurance carrier will pocket the increased yield.

Let's assume for the moment the cynics are correct, and that carriers have no regard for policyholders and deal only in their own self-interest. Well then, *is* carrier self-interest positively served by such behavior?

The answer is profoundly no. And here's why.

IUL products are mostly sold to clients below the age of 65 who will live for a long amount of time. If interest rates rise but caps do not, then an IUL product becomes less attractive compared to similar products issued by competitors with higher caps and higher client yields. Healthy clients, encouraged by agents and other advisors, will surrender their policy so that they can move to the more competitive products.   Furthermore, this would create another problem for the original carrier because the remaining pool would be the unhealthy, and this would result in more early death claims and therefore further losses.

Will the original life carrier care about these lapses? After all, they won't be paying a death claim and have already booked profit, as we noted above.

The answer is yes.

One of the great advantages of life insurance is that as standard practice the carriers guarantee the mark-to-market value of the bonds that support the cash surrender value. This was not an issue in a declining rate environment because the carrier could sell the attractive higher-yielding bonds and pocket the gain. However, when rates are rising and especially if the rise is rapid, the reverse is true. Thus, clients induced to surrender by higher caps elsewhere create a significant mark-to-market liquidation loss for the short-sighted carrier.

For example, if the insurer has a general account with an average bond maturity of ten years (typical for the industry) the losses would be a 9% loss on the cash value surrendered if there was a 1% increase in underlying market interest rates, and a 35% loss if there was a 5% increase. For a single client this is unpleasant but unlikely to break the carrier. However, if it happens on a large scale it creates an enormous loss that no senior management team is likely to survive.

Given the potential for considerable losses and that the carrier hits its profit objectives by passing through the increase in general account yield, the carrier is incented to pass through improved yields to the client in the form of higher caps. By doing so, the carrier attracts more premium while simultaneously protecting prior profits. By not doing so, the carrier risks mass surrenders which could result in the loss of hundreds of millions of dollars.

No one knows when interest rates will rise, but data and logic tell us that the life carriers will protect their profits. To do that they must pass on improved yields to the client in the form of increased caps and/or improved participation rates.

If your clients or their advisors have any questions on the above, please contact NIW.