

“Wow, there are a lot of opinions on Index Universal Life. Can we have some facts please?”

NIW Companies, Inc. has facilitated over \$4 Billion of loans for Index Universal Life (IUL) life premiums, and because we commit to support the designs for 15-25 years we have a strong interest in how those products work and how they are likely to perform over an extended period of time. The article below is designed to explain in plain English some of the arguments and present facts for the reader to allow them to make up their own mind.

This white paper will focus on the following areas that seem to have a lot of debate and opinions:

- How will an IUL perform vs. a regular Universal Life?
- Illustrated rates, are they realistic or not?
 - 20 yr. look back, what is missing?
 - Comparison to VUL returns can't be greater?
- Are the carriers taking advantage of you with caps or participation rate changes?
- The charges in an IUL, are they too high or not?
- Is the use of financing with IUL's sensible or not?

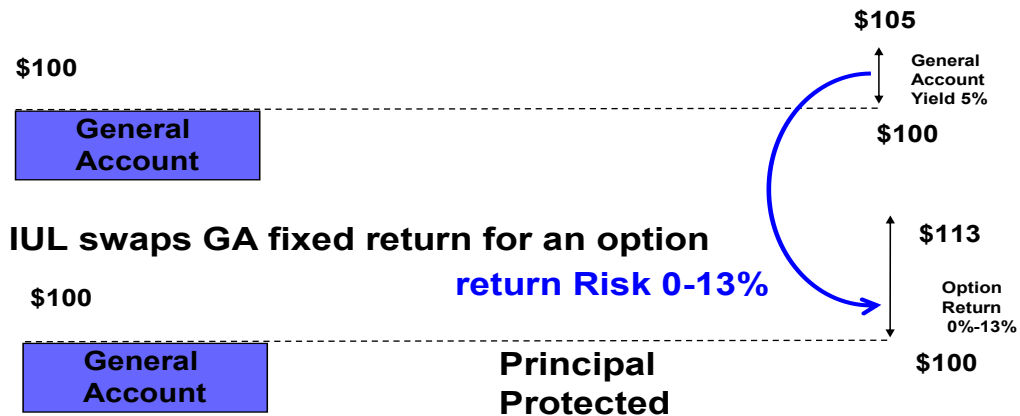
Let's first be clear of the underlying mechanics of an Index Universal Life (IUL) because a large number of life agents have conflicting information. For the most part the IUL is just a Universal Life (UL) but with a different method for crediting cash value growth in the policy. The cash value increases are through the use of an option, not direct investing into an Equity Index fund as many confuse it to be doing, (particularly in the advisor community). Critical to understanding though is what is used to buy the option. The option is paid for from the general account yield (return). So simplistically, if the UL product is generating a 5% crediting rate, that is what will be used to purchase the option. So (ignoring policy costs for the moment) if \$100 is paid as premium into the policy and the general account declared rate is 5%, then the carrier would put 95.25% of the premium into the general account knowing that with the 5% credit it would be back to \$100 at the end of the year. That is why an IUL cannot have a negative investment return. The 4.75% of the remaining premium is used by the carrier to purchase as big an option they could get. Let's assume that that 4.75% is sufficient to purchase an S&P point-to-point with a 13% cap on it. You can see the cap is essentially being driven by the budget available (this is a simplification explained later) but important for understanding as many clients I have spoken to are confused on where the money is

coming from to buy the option. The client is giving up the 5% they would have gotten otherwise.

So continuing this thought, if the general account return falls to 3% (due to low interest rates) then the carrier will only have 2.92% of the premium to purchase an option (97.08 X 3% growth=\$100), but as interest rates rise, and the general account return grows to, say 7% (the historical average of a typical general account), the carrier will have 6.54% of the premium to purchase an option. All things being equal, this allows a higher cap/participation rate. IUL's are a medium to long term hold product, so the real question as it pertains to caps is, what will be the average interest rate environment over the next 15-20 years be vs. today?

The impact on the actual cap/participation rate resulting from an increase/decrease in the general account return is not exact, because option prices are actually defined by the option budget (the amount of money you have available to spend), the risk that the option house will have to pay out more than they get for it (the volatility) and the underlying treasury rate. Note that only the return on the general account (i.e. the money the carrier was going to credit the policy holder anyway) is being used to purchase the option, hence the built-in principle protection on the underlying investment comes from the general account structure.

Difference between regular UL (fixed) policy and Index UL policy



Policy expenses have been ignored to help understanding
 Note the option budget is from the bond yield and so goes up
 Or down based on underlying interest rates/ bond yields

What does this mean? All that is really happening is that the policy holder is changing the relatively predictable “fixed income” return of a UL (fixed income bond yield) for the



more speculative return of an IUL, but the underlying premium “principle” remains the same. Why? Because, if the index market goes down, the option simply expires and the client is left with the \$100 (\$95.25X 5%) they originally put in. The speculative nature of the IUL return is the “risk” the client is taking versus the fixed income (declared rate) they would otherwise have earned. This increased risk factor is important and we will come back to this later.

How will IUL returns compare with UL returns?

This author has heard lots of opinions on this subject, most follow something like the comment that I heard on a carrier IUL product launch conference call. “All you are doing is flipping a coin, sometimes you will have a better result and sometimes worse, it will be the same over time”. This is a prevailing perspective amongst many, especially those whose background is selling the guaranteed returns associated with Whole Life policies. It does not take into account the different risk profile of the IUL vs. UL.

Given the earlier explanation, it is clear that the return on an IUL is more speculative and has more risk. So what extra return should a client expect for their increased risk? There are few published papers on this so NIW asked four of the leading indexed life carriers who have a significant history in the index market space. They will release their own papers in time hence the vagueness on names.

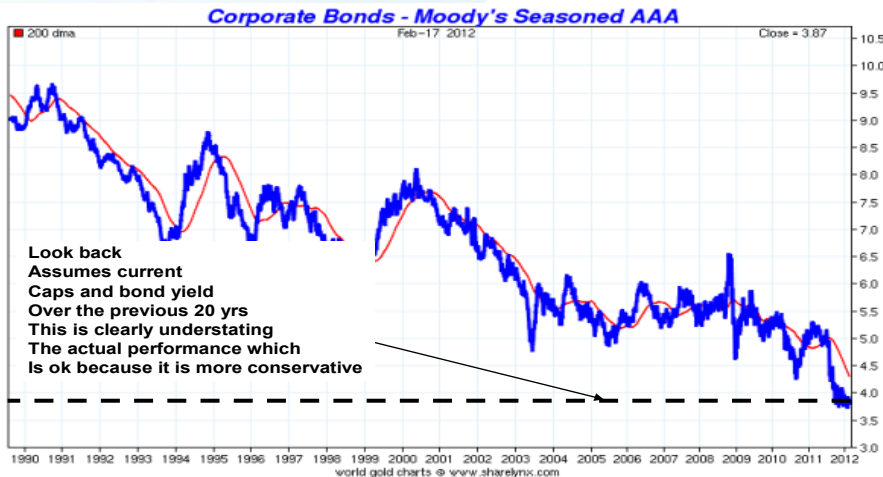
The question we asked was simple: ***“What is your expectation and or experience of the crediting rate difference if any, between your IUL products and the interest credits of your current assumption UL products.”*** The responses were both interesting and very consistent. All four carriers reported that they anticipate and/or observed indexed UL products will credit between +1.50% and 2.00% ON AVERAGE more than current assumption UL products when measured over time. This is consistent with the higher risk profile of the product. Logically why anyone would put their 5% (in this example) at risk if they did not believe over time they would get a better return?

Is the illustrated rate on the illustration software realistic?

Given what was mentioned above, why then do carriers not just show a return based on their experience described above? The first answer is that carriers really have not spent much time measuring the above and only some of them have started to measure and record the data. However it is also not really an appropriate way to measure the product. With current assumption UL products the carriers (due to the underlying investment) have a very predictable return expectation for the coming year so “declaring” a rate is relatively simple. With an IUL no one knows until the option matures what the credit will be and not all option strategies have the same risk profile (that is why they have different caps or participation rates). So the industry regulator has chosen to look at 20 year look back historical performance as the method of choice. Like every approach it has its pros and cons. What should be noted is that the look back approach uses the option budget of today not the historical actual option budget available in each of the years measured.



Historical Bond Chart and IUL Look Back



The above chart shows that using the option budget today is not reflecting the higher option budgets that would have been in place in the past.

Ironically this is not a bad thing for the IUL sector of the industry. If interest rates go up as all economists predict will happen over the next 10-15 years, then the option budgets will go up and in all likelihood caps will follow. So whereas in the 1980's Universal Life was launched in a high interest rate environment where rates had to come down to even get to their averages, so UL's illustrated at the high rate back then have not performed as originally illustrated because the underlying bond returns have declined with interest rates since the 1980's. The case can be made that an IUL illustrated today is likely to be assuming a lower cap than statistically will be the case over the next 15-20 years, i.e. the historically low interest rates has driven caps to a level significantly below their historical average. If the actual cap was used for each year the measurement was taken had been used IUL look back averages would typically be 25-35% higher than is currently being shown.

So will IUL's perform as per illustrated? Clearly the answer is no, but because caps are likely on average to be higher, it is likely that we are understating their performance if market conditions are the same as they have been over the last 20 years, i.e. uncertain. If we have the same 20 year markets but with higher caps then the math would say, better. If market conditions stagnate with very low return then no. If however my caps are higher, than obviously for the same market conditions my returns will be better. Ask yourself this question. Will interest rates be higher on average over the life of the contract? Everyone thinks so, even if not the immediate short term.



Measurement versus a Variable Universal Life (VUL)

One of the common comments from Broker Dealers in particular is that Variable Universal Life (VUL) products have more risk and therefore statistically will get better returns. So whatever our benchmark illustrated rate for VUL's is, the IUL should be below it. On the face of it this makes sense. However when you drill deeper, clearly this will only hold true in growth market conditions. Let's think about it. In a growth market clearly VUL's will outperform an IUL product. The risk reward is working for it, plus they can get dividends because they directly invest in the market. However if the market is volatile or negative, an IUL with its downside protection is likely to average a better rate of return than a VUL. Let's take the last 12 years as an example. Lets assume that the VUL was invested directly into an S&P index fund (this is simplistic, but it is just to illustrate a point.)

S&P 2000 to 2011 Volatile market			S&P 1988 to 1999 growth market		
Year	S&P	IUL 14% cap		S&P	IUL 14% cap
2000	-10%	0%	1988	12%	12%
2001	-13%	0%	1989	27%	14%
2002	-23%	0%	1990	-7%	0%
2003	26%	14%	1991	26%	14%
2004	9%	9%	1992	4%	4%
2005	3%	3%	1993	7%	7%
2006	14%	14%	1994	-2%	0%
2007	4%	4%	1995	34%	14%
2008	-39%	0%	1996	20%	14%
2009	27%	14%	1997	31%	14%
2010	11%	11%	1998	27%	14%
2011	0.64%	0.64%	1999	20%	14%
Average	0.76%	5.80%		16.75%	10.08%

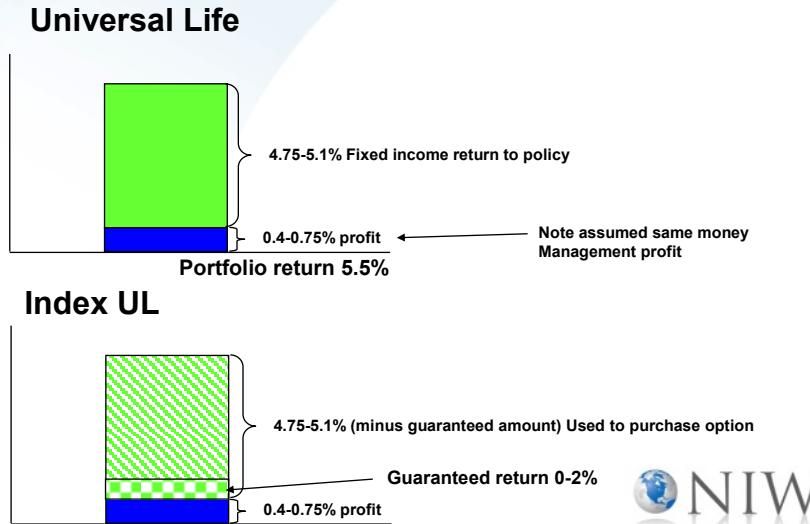
The key point here is not that one is better or worse than the other, but their differences will give different results in different environments, so it is too simplistic to say just illustrate it below whatever VUL rate we run, as clearly it is dependent on the market conditions being predicted. If conservative it is likely an IUL will out perform a VUL, if bullish the other way around. Given that recent history has been essentially negative I would argue that it does not make sense to show anything other than what they have averaged.

Are Carriers taking advantage of the client with caps and participation rates?

The quick answer is no more or less than they are with a current assumption UL or Whole life dividend rates!



Return is Profit Neutral to Carriers



The point of the chart above is that carriers take their “money under management fee off the top”, so to speak, so the declared rate on an UL is “net” of that fee. So the money being used to purchase the option is the “net” amount they were giving to the client anyway.

However the common argument we hear is that the real question is whether the carrier will pass on all the improvements or will they try to recover losses incurred when rates have been kept up artificially to maintain competitiveness. We have yet to hear a good response on this, but wonder if they needed to keep their rates up to be competitive, how they will be able to keep their rates down and no longer maintain competitiveness. The trick is to pick carriers whose core business is index because they HAVE to remain competitive and respond in kind to market pressures.

Are the Charges in IUL’s too high?

It has been well documented that IUL charges are higher than a regular UL product. While this author understands there is some increase in complexity on IUL crediting (the monitoring system that credits each policy based on their option choices and dates of maturity) but other than that there is little difference. As the monitoring should be essentially an automated system there seems to be little logic to the charges being higher on an IUL vs. a UL, we believe the charge difference allegation is unsustainable but it is what it is for now. **This is however not the key point.** The real question is whether those charges make a difference? This is where the correct use of the product becomes relevant.

The only real reason for using an IUL product is for cash accumulation, if clients want guarantees then it is not the product for them, guaranteed universal life products or

Whole life products are a better fit. ***But for a life insurance product to be effective at accumulation, it has to be over funded.*** The chart below shows full costs as a percentage of accumulation value for a carrier IUL (which carrier is not important as you will see). Each illustration run was run at the same assumed rate, etc., just the funding pattern changed. What we wanted to see was the cost as a percentage of the total cash value and its impact over time. What is noticeable is sustained over funding was key and that if the policy is overfunded on a sustained basis costs become increasing less important.

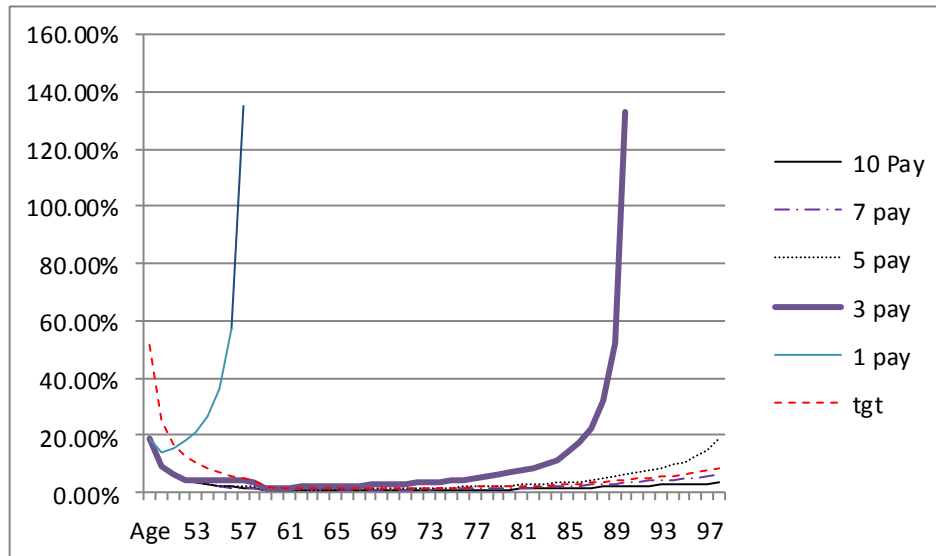


Chart is showing total policy costs including costs of insurance as a % of accumulation value.

Not surprisingly, when overfunded the IUL is a very efficient cash accumulation vehicle and the total costs become a very low number, less than 0.5% of accumulation value or less for a standard health, 50 year old, 10 max fund, premium design. Even at age 100 the costs were below 2-3% of the cash value. Given the overall percentage is so low, what is clear, is that the real client risk is in underfunding the policy, so minimum or low funding of IUL's has similar (all be it lower) risks to the underfunded VUL contracts seen in the 1990's, where natural changes in the yearly crediting (not shown in the illustrations) profoundly impacted the ability of the contract to remain in force and perform. So the issue is not really the charge differences but rather that agents show the real funding needed. It also shows why life insurance products are medium to long term hold products, as their initial acquisition costs are high but over time typically will have cost profit.

Should Financing be used with IUL's?

As mentioned above, for an accumulation product to work well, IUL's need to be overfunded 7-10 pay to the maximum levels in the opinion of this author. However, the



very attribute that makes them efficient is also the problem; they need a lot of cash! It also needs to be consistent. Using life insurance for cash accumulation applications has been around for a long time. One of the main reasons that those applications failed to achieve their numbers was the skipping of premiums. In good years clients funded, in bad years they didn't, and there lies the problem. The reality is that accumulation applications for the most part are business related; supplemental retirement, 409A, key man/buy-sell, but using cash value (accessed via policy loans) instead of death benefit to fix the problem. The application/problems they are solving are real and as relevant today as they have ever been, but all businesses have good and bad cash flow years and unless they can consistently fund the policies every year for 7-10 years they don't perform as planned.

This is not an IRR issue but a cash flow management issue. So why finance? Just like in our personal lives with any capital asset, i.e. personal homes, cars, business machines etc., we use finance (leverage) to ease the liquidity burden. The same is true for IUL's and any cash intensive applications. But how do we make it work?

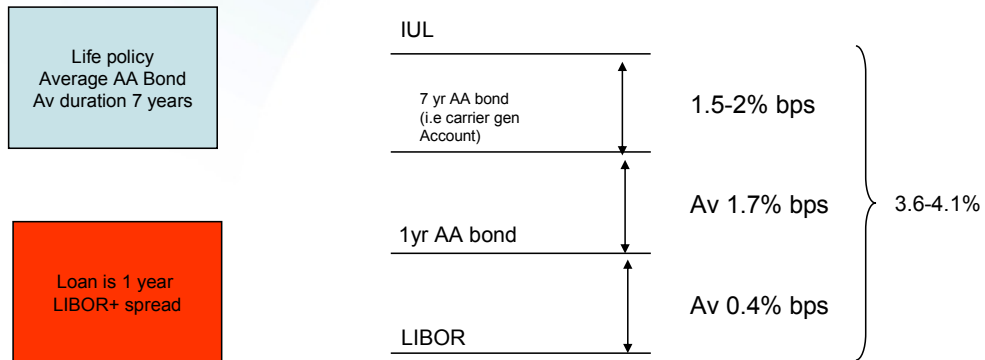
IUL's have something going for them that most fixed insurance products don't, "risk return", the idea that with the increased risk, there will be greater return over time. Obviously there is risk of that not happening but historical data on risk premium is fairly consistent irrespective of market cycles. This however can be critical when it comes to financing. BUT let's also be clear, the risk premium is RISK and therefore may not happen. However if the risk return holds true, and the loan price is low enough, then the difference between policy cash value growth and loan cost allows for financing to be used to ease the cash flow drain that would otherwise occur.

For this to work (and because there is risk this cannot be guaranteed) certain problems need to be over-come.



IUL Risk Spread vs UL and LIBOR

- To achieve loan exit we need to achieve 1.5% – 2.0% spread vs. cost of money (incl costs). To just obtain net Death Benefit approx. 1%



So to be safe loan pricing needs to be LIBOR+2% or less (target average <1.75%)-back test
Has found this to be consistent through multiple economic scenarios



For the financing to work well is the subject of a separate paper but essentially the following needs to occur:

- Over funding the policy to minimize the impact of contract costs
- Capitalized lending so interest payments don't become as big a burden as the premium would have been
- Loan costs need to be below 1 year Libor +2% on average to work statistically
- Post sale monitoring needs to be in place as with any financing

So financing has its place when done correctly with the appropriate supporting group, as it is probably the only realistic way to address the cash flow requirements needed in the typical accumulation application unless the policy owner is getting a low return on their own investments. Further information on financing of life insurance can be obtained by contacting NIW.

Daen Wombwell is the CEO and Co-Founder of NIW Companies, Inc., a national company that specializes in the financing of life insurance applications for both estate and business planning applications.

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