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The *WRNewswire* is created exclusively for AALU Members by insurance experts led by Steve Leimberg, Lawrence Brody, Linas Sudzius and AALU Staff. The *WRNewswire* provides timely reports and commentary on tax and legal developments important to AALU members, clients and advisors, delivered to your inbox as they happen.

Topic: Developments in the Indexed Universal Life ("IUL") Insurance Marketplace

CITES: NAIC Life Actuarial (A) Task Force Draft Actuarial Guideline IUL: Applying the Life Insurance Illustrations Model Regulation to Indexed Universal Life Insurance Contract Illustrations (August 14, 2014). ACLI Actuarial Guideline IUL; Coalition Alternative Actuarial Guideline IUL

SUMMARY: IUL sales have been expanding greatly in recent years, while also prompting some questions, concerns and regulatory attention/activity, especially with regard to the maximum illustrated crediting rate used in the IUL illustrations. Because of the growing significance of the product, this Washington Report is intended to provide an industry update on developments related to this marketplace.

Whether or not particular life insurance advisors sell meaningful amounts of IUL, given its increased prevalence, it is important to be aware of the nature of the product's appeal and pertinent regulatory developments, questions and concerns. A significant factor in the appeal of IUL can be attributed to the product's image as a relatively safe way for consumers to fund their insurance needs and to participate in the upside of the stock market, without investment exposure to market downsides.

However, some in the industry are concerned that consumers do not have a good understanding of the complexities of this product and may have an overly optimistic sense of how IUL will perform, in part due to non-standardized illustrations which are difficult for consumers to assess. As noted in recent reports in the *Wall Street Journal* and other publications, the New York State Department of Financial Services has opened an investigation into IUL sales practices of 134 insurers that operate in NY, by inquiring as to the presentations of the potential gains to prospective consumers.

In addition, the National Association of Insurance Commissioners' ("NAIC") Life Actuarial (A) Task Force is currently considering a draft actuarial guideline for IUL proposed by the American Council of Life Insurers ("ACLI")(with approval by the ACLI Board) with the goal of helping consumers better understand IUL product performance and crediting/interest rate variability. The NAIC task force is also considering an alternative approach proposed by MetLife, New York Life, Northwestern Mutual, and OneAmerica, which focuses on the development of investment return factors underlying IUL policies.

We will closely monitor developments as the NAIC and the industry continue to assess this product's illustrated performance and consider standardization/reform. At this juncture, it appears that reform/standardization of illustrations will help, but by itself may not necessarily ensure that clients understand the product, its risks, dynamics that are in play, and have realistic expectations of the product's market performance.

WHAT IS IUL?

Like fixed universal life ("FUL") and variable universal life ("VUL"), IUL is a cash value life insurance policy. IUL offers fixed and indexed account choices, backed by the general account of the carrier, which provide clients with flexibility in structuring the death benefit, the length of coverage and the premium obligation.

Unlike with FUL, where cash value is credited at a fixed interest rate, or with VUL, where the actual investment returns of specific investments through policy "subaccounts" are passed directly to the policyholder, IUL credits interest based on the performance of the stated index, subject to certain parameters, described below. Common market indices include the S&P 500, DJIAA, Russell 2000, EURO STOXX 50, and Hang Seng.

In an IUL, each time a premium payment or an amount from the fixed account is allocated to an indexed account, a new policy segment is created. At the end of the segment term, interest is credited based on return of the index subject to the current growth cap, floor, and participation rate of that account. Typically, carriers set up these segments on a monthly basis.

Key terms of an index account are:

- **Index Parameters:**
    - **Cap Rate:** The maximum interest credit offered at that point in time. If the index return is lower than the cap rate, the interest credited is lower. If the market performance is higher, the interest credited is limited to this rate.
    - **Floor:** The minimum guaranteed crediting rate. If the index return is lower than the floor, the interest credited will not be less than the floor.
    - **Participation Rate:** Determines how much of the index return will be used to calculate the indexed credit.
- **Segment Term:** The period of time the segment remains active. A segment's term is determined by the indexed account in which it is held. In the industry, a common segment term length is 1 year. Longer terms are also available, such as 2-year, 3-year, or 5-year periods. The longer periods generally offer higher participation rates or caps.

- **<u>Crediting Method:</u>** This is the calculation method used to determine the market return over the segment term.
  - **Point-to-Point:** Where the index return is calculated using beginning and ending index values. The most common segment length for a point to point is 1 year but longer periods are seen as well, such as 2-year and 5-year terms.
  - **Monthly Point to Point:** Where the index return is based on the sum of monthly returns (capped and floored).
  - **Monthly Averaging:** Where the index return is based on the change between the average index value over the segment period and the index value at the beginning of the segment term.
- **<u>Credited Interest Rate:</u>** The interest rate applied to the segment. This rate is determined by index performance, participation rate, growth cap, floor and crediting method.

Here is an example of how interest is credited:

Cap	Floor	Participation Rate	Market Return	Interest Credited Rate
12%	0%	100%	15%	**12%**
12%	0%	100%	-10%	**0%**
12%	0%	100%	8%	**8%**

OTHER IUL DYNAMICS

It is important in setting expectations with clients, that they understand:

- The upside crediting rates for IUL do not generally include the appreciation that is attributable to dividends from stocks in the index.
- The cash value of IUL, VUL, and FUL will decline if the policy charges, such as the cost of insurance—which can change significantly over the life a contract—exceed the amount of the credited interest and premium deposits.
- After the initial IUL segment, carriers have the right to adjust the cap and participation rates down to lower minimum rates provided by the IUL contracts, or, if conditions warrant, raise these rates (note: carriers also have the right to lower or raise credited rates on FUL contracts).

Many carriers invest in a combination of fixed income instruments (bonds) and buy call options for both upside potential and downside protection—sometimes called “call spreads”—from third parties, such as investment banks. The ability of carriers to offer caps and participation rates may vary depending on the management of their respective general accounts, as well as economic conditions. Some within the industry have expressed concern that current conditions enable carriers to offer higher cap rates and participation rates for IUL policies than may be sustainable over the long run. The IUL carriers, some of whom have been writing IUL for close to a decade, indicate there has been a track record for stable caps.

Another option policy owners can consider with IUL policies relates to policy loans. There are typically three types of IUL loans available:

- Fixed Loans—the loan interest charge and the loan interest credit are fixed (or the "spread" between the interest charge and credit is fixed), with zero net-cost or "wash" loans sometimes available after a period of time.

- Participating Loans—the loan interest charge is fixed, while the loan interest credit is equal to indexed interest credit (determined by the pertinent cap rate, participation rate and other parameters set by the IUL).

- Variable or "Indexed" Loans—the loan interest charge is tied to an external index (e.g., Moody's AAA Bond), while the loan interest credit is equal to indexed interest credit (determined by the pertinent cap rate, participation rate and other parameters set by the IUL).

In taking a participating, variable or indexed loan—rather than a fixed loan—the policy owner is currently operating on an expectation that the IUL returns will exceed the applicable loan rate. Some carriers have expressed concern that policy owners could suffer significant disappointment if this expectation is not met over the term of the loan.

IUL ILLUSTRATIONS

The National Association of Insurance Commissioners' (NAIC) Life Actuarial (A) Task Force is currently considering a draft actuarial guideline for IUL proposed by the ACLI with the goal of helping consumers better understand IUL product performance and crediting/interest rate variability, as well as an alternative approach offered by a coalition including MetLife, New York Life, Northwestern Mutual, and OneAmerica , which instead focuses on the development of investment return factors underlying IUL policies.

The bulk of life insurance products, including IUL products, are governed by the Life Insurance Illustrations Model Regulation which was adopted by the NAIC in 1993. That regulation, which pre-dates IUL policies, provides significant flexibility in how these products are illustrated.

The NAIC is concerned that in the absence of more specific uniform guidance for illustrating IUL policies, companies can develop illustrations that may provide an overly optimistic view of the potential upside offered through the policies, which could be confusing to potential buyers when comparing products among companies and can cause uncertainty among illustration actuaries when certifying compliance with the model regulation.

While some consider IUL as a hybrid product which shares some characteristics of fixed products and securities products, IUL is not treated as a security and therefore is not governed by requirements and oversight of the Securities and Exchange Commission, which are applicable to VUL policies.

ACLI PROPOSAL

The draft NAIC Actuarial Guideline for IUL proposed by the ACLI would define standards to be used by the illustration actuary. It would stipulate that IUL illustrations have a maximum illustrated rate based on a standardized look-back period of 25 years—intended to be sufficient to demonstrate a full economic cycle.

The ACLI's proposed actuarial guideline features the mechanisms below, which were intended to foster more realistic consumer expectations and increase consumer awareness of the variability of returns.

<u>Imposition of a 10% maximum illustrated rate:</u> This maximum was set to handle a range of future economic environments, index account designs and product designs.

<u>Inclusion of a midpoint scenario in addition to the input scenario</u>: This additional scenario would be unique to IUL, and would show the impact of lower interest rates to the various features of an IUL policy. It would also provide a safeguard when indexed loans are being illustrated—for example, if illustrated rates were to be less than the loan charges or if there were a reduced spread between the loan and credited rates, the loan mechanics would become more transparent.

<u>Inclusion of a historical look back table of at least the 20 most recent consecutive calendar years of index performance:</u> This table would illustrate the potential variability of returns from year to year so consumers know not to expect a level interest/crediting rate in all years. **While the numbers used were hypothetical**, the proposal provided an example of what the table might look like—showing a 20-year (1994-2013) point-to-point option with an annual average return of 7.3 percent, but which included 10 years of 12 percent growth and 5 years of 0 percent growth.

<u>Inclusion of a second table to disclose the impact that changes (in steps from current to guaranteed minimum) to the cap and participation rates would have on the non-guaranteed interest rate:</u> **While the data used is hypothetical**, the following is an example of this potential impact:

Currently Illustrated Parameters	25% Reduction in Index Parameters	Average of Current and Guaranteed Minimum Parameters	75% Reduction in Index Parameters
12% Cap	9.75 % Cap	7.5% Cap	5.25 % Cap
7.5% Non-Guaranteed Interest Rate	6.5% Non-Guaranteed Interest Rate	5.0% Non-Guaranteed Interest Rate	4.5% Non-Guaranteed Interest Rate

ALTERNATIVE PROPOSAL

In proposing an alternative approach which is also under consideration by the NAIC task force, MetLife, New York Life, Northwestern Mutual Life, and OneAmerica (which do not currently offer IUL products) expressed concern that the ACLI proposal would "in essence codify existing illustration practices which may result in misleading illustrations and ultimately lead to consumer disappointment regarding the performance of the product." Its proponents believe the alternative proposal would have the following benefits: (1) create IUL illustrations that are in line with and reinforce IUL's status as a general account product; (2) show illustrated rates that reflect supportable assumptions; and (3) eliminate what proponents of the alternative proposal call "arbitrage" illustrations and show returns more in-line with the low-risk nature of the product.

Rather than focus on the illustrated crediting rate itself, the alternative proposal would provide guidance to the illustration actuary in setting the investment return assumption used in supportability testing as required by the illustration regulation—particularly regarding derivative instruments commonly used to hedge index-related potential upside for IUL policy owners. Proponents of the alternative proposal indicate that some academic literature and other data support an assumption that there will be no long-term, systematic and sustainable profits from purchasing derivatives. (Note: proponents of the ACLI proposal cite contrary literature and data). The alternative proposal would allow for a profit of up to 12 percent if this return is justified under supportability testing. The alternative proposal would allow for minimum index guarantees above 0 percent, by requiring that the portion of the investment return supporting the guarantee should be carved out before investing in hedge assets.

While the numbers below are hypothetical, to illustrate the above, the alternative proposal would focus on the maximum return from purchasing derivatives. For example, assuming that a life insurance carrier's general account has an annual return of 4.25 percent, and assuming a 4.25 hedge budget could buy a 12 percent cap for a 1 year, point-to-point account, the maximum investment return assumption that could be used for Illustration supportability testing under the alternative proposal for the 20 year period would be 4.76 percent.

Hedge Budget Purchased from Return on from General Account	Times (x)	Maximum Return (%) on Derivative Investment, if Supportable	Equals (=)	Maximum Investment Return Assumption allowed under Alternative Proposal
4.25%	x	1.12 (12%)	=	**4.76%**

THE CHALLENGE IN ENSURING THAT THOSE CLIENTS WHO CONSIDER IUL UNDERSTAND IT

We will closely monitor developments as the NAIC and the industry continue to consider the standardization/reform of IUL illustrations. At this juncture, it appears that reform/standardization of illustrations will help, but by itself may not necessarily ensure that clients understand the product, its risks, dynamics that are in play, and have realistic expectations.

Current caps and floors, and therefore, the illustrated look-back rate, are determined by the current cost of the options to hedge the underlying index. Option costs vary over time—sometimes significantly so—based on the overall interest rate environment and market volatility and could materially impact the upside participation available in an IUL policy. While carriers are clearly able to back-cast the performance of the pertinent index or indices, illustrations may convey the impression that participation, cap, and floor rates would remain static.

In addition, while an illustration could show a return of zero in a given year if the pertinent index or indices stayed the same or declined in a given year, the policy's cash value could decrease because policy charges are still deducted. Depending on the sequencing of this type of occurrence—for example, if it were to occur in the early years of the policy— and the timing of premium payments, there could be a significant impact on the cash value over the life of a policy.

The illustration of participating, variable or indexed policy loans for IUL at the time of policy purchase can potentially distort client expectations to the extent that the client believes that the static picture in the illustration depicts what the client will actually experience.

For example, the most aggressive illustrations currently show illustrated values increasing by the maximum projected return not only during the phase of accumulation, but also when withdrawals occur from the policy start date. If this maximum rate is illustrated with internal borrowing at a lower fixed rate, it can give the client the expectation that the cost of insurance may be subsidized by index gains over the life of the contract. This result is predicated on consistent years of increase, whereas a flat or declining equity market could instead produce zero or negative results (when coupled with other policy charges) on the cash value in some years.

While a client may appropriately decide to take a participating or indexed loan from an IUL, such decisions likely are better made after a policy is in force—taking into account information available on a regular basis—rather than based on projections at the time a policy is purchased. IUL also offers standard policy loans without exposure to index returns. The use of standard versus participating loans should be considered relative to each client's time horizon, financial objectives and risk tolerance.

RELEVANCE:

- Whether or not particular life insurance advisors sell meaningful amounts of IUL, given its increased prevalence, it is important to be aware of the nature of product's appeal, pertinent regulatory developments, questions and concerns.

- A significant factor in the appeal of IUL can be attributed to the product's image as a relatively safe way for purchasers to participate in the upside of the stock market, without investment exposure to market downsides.

- However, some in the industry are concerned that consumers do not have a good understanding of this complex product and may have an overly optimistic sense how IUL will perform, in part due to non-standardized illustrations which are difficult for consumers to assess.

- As noted in recent reports in the *Wall Street Journal* and other publications, the New York State Department of Financial Services has opened an investigation into IUL sales practices.

- The National Association of Insurance Commissioners' (NAIC) Life Actuarial (A) Task Force is currently considering a draft actuarial guideline for IUL proposed by the ACLI (with approval by the ACLI Board) with the goal of helping consumers better understand IUL product performance and interest rate variability. The NAIC task force is also considering an alternative approach proposed by MetLife, New York Life, Northwestern Mutual, and OneAmerica, which focuses on the development of investment return factors underlying IUL policies.

- We will closely monitor developments as the NAIC and the industry continue to consider the standardization/reform of IUL illustrations.

- At this juncture, it appears that reform/standardization of illustrations will help, but by itself may not necessarily ensure that clients understand the product, its risks, dynamics that are in play, and have realistic expectations.

- Best practice is to help ensure that: (1) clients understand that IUL is a general account product, rather than a separate account which holds investment assets, (2) clients understand that IUL is not treated as a security and therefore not governed by requirements and oversight of the Securities and Exchange Commission, and, particularly, (3) clients understand the range of outcomes that are likely to occur, rather than to project a single result.

- One longer-term issue that goes beyond IUL to the range of life insurance products is finding ways to identify and clearly communicate reasonable assumptions, costs and considerations to clients in a concise way, recognizing that the increases that have occurred over time in the type, form and volume of disclosures can themselves increase complexity for clients and do not necessarily promote enhanced understanding.

- The AALU will continue to stay in touch with industry partners and practitioners regarding IUL, listen to input and provide updates, as appropriate.

***WRNewswire* #14.10.09 was written by Tom Korb on the AALU staff.**

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