

M INTELLIGENCE

LEVERAGED IUL MULTIPLIERS

This M Intelligence piece provides a deeper understanding of leveraged indexed universal life (IUL) multiplier products and their potential for performance volatility, as well as the effect of regulatory changes on illustrations for both new and in-force products.

IUL multipliers and leveraged IUL multipliers offer a compelling option for clients seeking upside performance with downside protection. These are great products for many people, but with leveraged IUL multipliers in particular, comparisons aren't always as simple as the illustrations make them appear.

BACKGROUND

When introduced in 1997, IUL netted a tidy half-million dollars in sales. In 2017, IUL products accounted for almost 60% of all universal life premiums — about \$2.5 billion in annualized premium sales. Some of this growth was likely due to a lack of regulation and uniformity in the methods used to illustrate IUL. This led to some carriers adopting methods that produced very competitive illustrations.

That changed when Actuarial Guideline XLIX (AG 49) was adopted in 2015 by the National Association of Insurance Commissioners (NAIC). AG 49 sought to bring uniformity to IUL illustrations and promote easier comparison of IUL policies. One of the changes AG 49 brought was to set limits on the maximum illustrated crediting rate that companies can use for IUL products.

After AG 49 was introduced, new IUL product designs emerged, such as the leveraged IUL multiplier, a variation on an IUL multiplier design. The IUL multiplier

design offers better returns than traditional IUL when the index returns are more volatile — that is, more returns below the cap rate. The leveraged IUL multiplier design uses an additional charge to buy more options — that is, leverage up the returns.

When illustrated at the AG 49 maximum rate, leveraged IUL multiplier products generally perform better than the more established traditional IUL designs. Not surprisingly, leveraged IUL multiplier designs saw strong sales in 2018.

AG 49 Regulation for IUL Illustrations

- Effective in 2015
- Limits the maximum illustration rate
- Limits leveraged loan illustration spread
- Applies to all IUL in force

The news is not all rosy, however. Leveraged IUL multiplier products have increased risk of downside performance when index returns over time are lower than the illustrated rate or market volatility increases the cost of index options.

At a NAIC meeting in November 2018, concerns were raised that leveraged IUL multiplier designs were not consistently illustrated with the intent of AG 49, and it was agreed to review AG 49 with respect to these new designs. Considering that AG 49's rules were applied to all in-force IUL policies retroactively, with no grandfathering, it is reasonable to expect that any future changes in the rules would be applied retroactively as well.

For these reasons, producers should take extra care when using illustrations to set client expectations for future policy performance and emphasize the importance of ongoing policy reviews to keep the coverage on track.

TRADITIONAL IUL

The interest credits of traditional IUL products are based on the return of an underlying benchmark index, such as the S&P 500. For example, the S&P 500 one-year, point-to-point index credits interest equal to 100% participation in the net change in the S&P 500 index from the first date to the last date of the benchmark period, subject to a cap and a floor.

To accomplish this S&P 500 index strategy, the insurer invests most of the account value in its general account and the remaining smaller portion in an options strategy, which is usually a combination of buying and selling index options to achieve the desired option payoff amount. The option cost is the net cost of the options strategy; that is, the sum of combined buying and selling of the index options. The option payoff provides the policy interest credits between the floor and the cap. In Example 1, the growth in the amount invested in the general account portfolio provides the account value floor, and the option payoff provides the upside growth, or net policy return.

LEVERAGED IUL MULTIPLIER DESIGN

Since IUL was introduced, carriers have offered many variations on IUL crediting strategies, allowing for better illustrations when compared to the popular S&P 500 one-year, point-to-point strategy. Since the adoption of AG 49, the attraction of variations like the leveraged IUL multiplier is that they allow for better illustrations when run at the AG 49 maximum limit. Compared to a traditional IUL, which tends to incorporate the option cost into the investment allocation, the leveraged IUL

multiplier design uses increased policy charges to pay for additional options. This will generate higher net policy returns than a traditional IUL when the option payoff exceeds the option cost. Conversely, the leveraged IUL multiplier will generate a lower net policy return when the option payoff does not exceed the option cost.

EXAMPLE 1

Imagine \$100 in an S&P 500 index account. At the beginning of the benchmark period, the insurer allocates \$96 to the general account and \$4 to purchase the options strategy. Say the S&P 500 price change over the period is 6%. Then, at the end of the benchmark period, the interest credits to the policy are based on the returns of each component.

TRADITIONAL IUL EXAMPLE				
	S&P INDEX RETURN			
	0%	4%	6%	10%
Beginning Account Value	\$100.0	\$100.0	\$100.0	\$100.0
Option Cost	\$(4.0)	\$(4.0)	\$(4.0)	\$(4.0)
General Account Investment	\$96.0	\$96.0	\$96.0	\$96.0
General Account Earnings	\$4.0	\$4.0	\$4.0	\$4.0
Option Payoff	\$0.0	\$4.0	\$6.0	\$10.0
Ending Account Value	\$100.0	\$104.0	\$106.0	\$110.0
Net Policy Return	0.0%	4.0%	6.0%	10.0%

EXAMPLE 2

Let's look at the impact on Example 1 if we increase the policy charges to purchase \$6 in the options strategy, instead of \$4. (\$4 to buy options, which provides the traditional cap/floor, and \$2 to buy additional options, which provides the increased leveraged return.)

The general account investment will now be \$94 instead of \$96. To maintain the account value floor of \$100, the option payoff must be sufficient to restore the beginning account value. In this example, when

the S&P index returns 6%, the option payoff will be \$9, because we purchased 50% more options. However, if the option payoff is \$0, the policy will incur a loss of the \$2 increased option cost, plus the lost general account interest. Even though the \$2 increased option cost is considered an additional policy charge, these products are still marketed as providing a 0% floor because the option payoff will never be negative.

LEVERAGED IUL MULTIPLIER EXAMPLE				
S&P INDEX RETURN				
	0%	4%	6%	10%
Beginning Account Value	\$100.0	\$100.0	\$100.0	\$100.0
Option Cost	\$(6.0)	\$(6.0)	\$(6.0)	\$(6.0)
General Account Investment	\$94.0	\$94.0	\$94.0	\$94.0
General Account Earnings	\$3.9	\$3.9	\$3.9	\$3.9
Option Payoff	\$0.0	\$6.0	\$9.0	\$15.0
Ending Account Value	\$97.9	\$103.9	\$106.9	\$112.9
Net Policy Return	-2.1%	3.9%	6.9%	12.9%

Illustrations and The Multiplier Concept

When comparing traditional IUL and leveraged IUL multiplier illustrations, it may not be obvious that the illustration crediting rate input into the illustration system is used to set the option payoff rather than the net policy return. Thus, a 6% input for traditional IUL illustrates an option payoff of \$6, and the same 6% input for a leveraged IUL multiplier illustrates an option payoff of \$9.

EXAMPLE 3

A 6% illustration input results in a 6% net policy return for the traditional IUL and a 6.9% net policy return for the IUL multiplier. Conversely, a 2% illustration input results in a 2% net policy return for traditional IUL, compared to a 0.9% net policy return for the multiplier. Compared to a traditional IUL product, the net policy return for the IUL multiplier will be lower when the option payoff is not high enough to cover the added option cost and higher when the option payoff exceeds the amount needed to cover the added option cost.

This example compares a traditional IUL and IUL multiplier of the option payoff vs. the net policy return for a range of illustration crediting rate inputs.

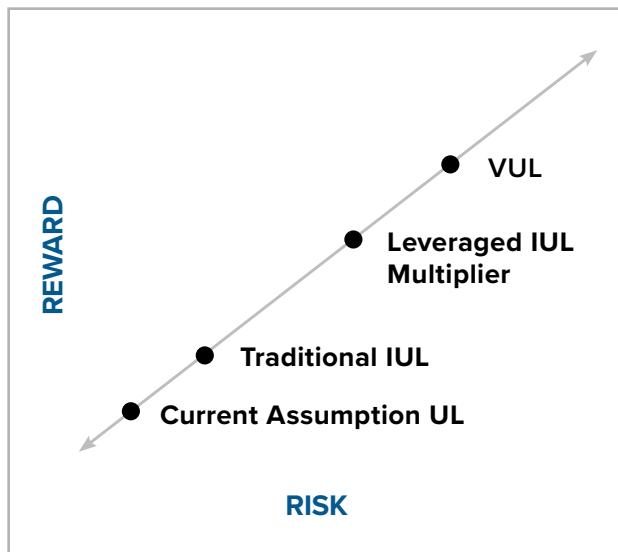
Illustration Crediting Rate	TRADITIONAL IUL		IUL MULTIPLIER	
	OPTION COST: \$4		OPTION COST: \$6	
	Option Payoff	Net Policy Return	Option Payoff	Net Policy Return
0.0%	\$0.0	0.0%	\$0.0	-2.1%
2.0%	\$2.0	2.0%	\$3.0	.9%
4.0%	\$4.0	4.0%	\$6.0	3.9%
6.0%	\$6.0	6.0%	\$9.0	6.9%
8.0%	\$8.0	8.0%	\$12.0	9.9%
10.0%	\$10.0	10.0%	\$15.0	12.9%

Example 3 shows that the long-term impact of the multiplier can be significant. The traditional IUL illustration is compounding at 6% annually, compared to the leveraged IUL multiplier compounding at 6.9% annually. For example, \$10,000 may grow to \$102,000 at 6% versus \$145,000 at 6.9%.

While a leveraged IUL multiplier may have great long-term results, the improved illustration performance over traditional IUL relies on option costs and general account earnings rates staying the same and returning a compounded 6.9% each year. Realistically, option cost will likely vary based on changes in market volatility and other factors, and general account earnings will vary as interest rates change. Additionally, tools to illustrate the added risk and reward of leveraged IUL multiplier mechanics are not readily available. Due to AG 49 regulations, testing leveraged IUL multiplier performance against prior illustrations proves impossible.

IUL DESIGN MULTIPLIER CONSIDERATIONS

- IUL multiplier returns are more volatile than traditional IUL.
- At AG 49 maximum rates, IUL multiplier performs better than traditional IUL.
- Review illustrations at various lower illustration crediting rates; for example, running an illustration at 4% may show what happens if the option payoff is closer to the option cost.
- Reinforce the importance of in-force monitoring of the policy and that funding adjustments may be necessary to achieve the client's objectives.
- NAIC Illustration Regulations can restrict the crediting rate, which may be illustrated, and also apply to in-force illustrations based on future conditions.



LOOK-BACK RATE CALCULATION FOR IUL ILLUSTRATIONS IN 2019

1. Calculate index look-back rate, compound annual growth rate (CAGR), based on historical performance for each 25-year period beginning in Jan. 1, 1953, through Dec. 31, 1993.

Roughly 250 trading days per year x 40 years = 10,000 25-year CAGRs periods.

2. Then calculate the average of the returns for each 25-year period (takes average of the 10,000 CAGRs).
3. Repeat the same calculation for the benchmark index (e.g., S&P 500) with 0% floor and cap based on what the product charges can support. For example, one product could support a cap of 10% and another product may have higher charges and be able to support a higher cap like 11%.
4. Then the lower of the index look-back rate and the benchmark look-back rate becomes the illustration max.

ACTUARIAL GUIDELINE XLIX (AG 49)

FACT SHEET

- Regulates the illustration of policies with index-based interest
 - Limits maximum crediting rate that can be illustrated
 - Limits amount of policy loan leverage that can be illustrated
 - Requires an alternative ledger and additional disclosures to the illustration
- Effective for new business issued after Sept. 1, 2015
- Retroactively applied to illustrations of all in-force business effective March 1, 2017
- Prescribes method to calculate a look-back rate for a given index
 - The average of 25-year CAGRs of the previous 65 years
 - 25-year periods start each trading day for the 65 years prior to December 31 of the previous calendar year
- Maximum rate for a given index is capped by the lower of:
 - Look-back rate based on index methodology, or
 - Look-back rate based on a benchmark index (defined to be the S&P 500, one-year, point-to-point, 0% floor, 100% participation, and a cap that the product can support), or
 - Any limitation from the Illustration Model Regulation tests using prescribed method
- For illustrations with loans, the rate credited to the loan balance cannot be more than 100 basis points (i.e., 1%) higher than the illustrated loan charge

Carlson Hammond

CA (415) 256-8960 | HI (808) 532-2826 | carlsonhammond.net

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M Financial Group | 1125 NW Couch Street, Suite 900 | Portland, OR 97209 | 503.238.1813 | fax 503.238.1815 | mfin.com