Insurance and Annuities

INDEXED UNIVERSAL LIFE INSURANCE

The Universal Life Concept

- Universal life insurance provides permanent life insurance protection that is enhanced by unique product features, including flexible premium arrangements and adjustable death benefits.
- An important characteristic of universal life insurance is the potential for faster cash value growth than is possible with whole life insurance.
- As with all types of cash value life insurance, poor policy performance, excessive distributions, and underfunding can cause a policy to lapse. Policyowners are responsible for managing the policy to keep it in force.

Premium Flexibility

- To meet changing needs, the owner of a universal life policy may increase or decrease the premium or (in certain cases) skip a premium payment altogether. These premium variations are permitted as long as the cash value is sufficient to keep the policy in force.
- Paying smaller amounts and skipping premiums both require careful consideration, since either action can deplete the cash value and cause the policy to lapse.
- Paying larger premiums than those required to maintain the death benefit can help grow the cash value. The only limitation is that the insured must maintain a certain amount of pure insurance protection not attributable to cash value.
- Paying premiums that exceed certain limits will cause policy withdrawals or loans during the insured's lifetime to be subject to income taxes and potentially a 10% excise tax.

Death Benefit Flexibility

- The policyowner may also increase or decrease the universal life death benefit.
- The insurer's approval is required when a policyowner requests an increase, since the insured must still be insurable. If a higher death benefit is approved, the minimum premium will increase.
- Although approval is required when the policy owner requests a decrease in the death benefit, insurability is not an issue.

Death Benefit Options

- Another unique feature of universal life is the option to select one of two different death benefit arrangements.
- The first—called Option A or Option 1—is a level death benefit equal to the face amount of the policy, with the cash value as part of the benefit instead of a separate amount. This allows the cash value to provide some of the death benefit, reducing the amount the insurance company must pay when the insured dies. This is identical to the death benefit in a traditional whole life policy.
- The second arrangement—called Option B or Option 2—offers an increasing death benefit consisting of the policy's face amount plus the accumulated cash value. In this case, growing cash value accounts for the increased death benefit. This will result in larger internal policy charges than Option A because the insurer must provide the whole face amount.
- The nature of Option B means the exact death benefit is not known until the insured's death, when the accumulated cash value is added to the face amount of the policy.
- Some insurers also offer an Option C, where the death benefit is the face amount of the policy plus aggregate premiums paid, less any cash value distributions.
- Policyowners may be able to change options during the life of the policy. Proof of insurability is required to change from Option A to Option B, since a greater amount of insurance will become available.

The Indexing Concept

- An indexed UL policy includes a feature that may increase the potential for greater cash value growth.
- This feature links growth to a widely recognized market indicator or index (such as the S&P 500®), which can result in the payment of a greater return than policies without an indexing feature.
- If the index goes up, the credited interest will go up.
- If the index goes down, the credited interest will also decline, but this decrease is limited to a minimum guaranteed interest rate. In other words, the actual credited interest will be either the guaranteed rate or the interest generated by the index, whichever is greater.
- While the credited interest is linked to an index, there is no actual investment in equity products. The policy avoids the risk of investing in equities while still having the potential for higher returns.

Indexed Crediting Options

- Insurers offer one or more methods of crediting earnings to the cash value account of an indexed universal life policy. The insurer uses the selected method to measure the change in the index from one date to another.
  - The **annual reset (or ratcheting) method** compares the index value at the beginning of the year to its value at the end of the year.
  - The **point-to-point method** is similar to the annual reset except over a longer period of time—often five years.
  - The **high-water-mark method** compares the index value at the start of a specified period to the highest value reached during that period.
- Consumers may choose to place a portion of their premiums in a traditional fixed-interest account rather than in the indexed account. In this case, the insurer declares an interest rate for a certain period and this rate is credited to the fixed account.

Other Features of Indexed Policies

- Indexed policies include a contractual participation rate, which is the percentage of the index gain that will actually be credited to the policy. This percentage is typically 100% but can be as little as 50%. A 100% participation rate means if the index gain is 3%, the credited rate will be 3%. However, if the participation rate is 90%, for example, the credited interest rate will be 2.7% (90% × 3%).
- Insurers may also set a cap rate on the percentage increase that will be paid. For example, if the cap rate is 8%, no more than 8% will be multiplied by the participation rate to determine the credited rate. For example, if the participation rate is 100%, the index gain is 6% and the cap rate is 5%, 5% is the maximum that will be credited, even though the index gain is greater.

Applying the Premium

- When a premium is paid, it goes first to what is termed a fixed basic interest “strategy” from which required policy charges and fees are deducted (the cost of the insurance, administrative charges, policy fees, etc.). The remainder is sent to the fixed or indexed crediting strategy selected by the policyowner.
- For a new policy, a specific amount must be accumulated in the fixed account before the excess can be directed to one of the indexed strategies.

- The amount directed to the indexed strategy is often called a segment or bucket. Once the fixed basic interest segment has enough value to pay policy charges and the cost of insurance for the required period, the excess is directed to the selected fixed or indexed strategy. A segment is typically created monthly or quarterly, depending on company practice.
- A new segment is created each time a premium is directed to a certain strategy. Each segment is subject to its own participation rate and cap rate, depending on the rates the company is applying at that time.

Timing of the Index Crediting

- Each segment remains in the selected strategy until the end of the index period. For example, the strategy might be a one-year or five-year strategy, which means the index period is one or five years. At the end of the index period, insurers may permit the segment to be transferred to a different strategy.
- On the date of deposit, the beginning index value is recorded. Insurer practices can vary with respect to when the change in the index is calculated and credited. For example, if the segment term is five years, the insurer may credit interest annually on each anniversary of the segment creation date.
- At the end of the period prescribed by the insurer, the change in the index is determined and the amount to be credited is calculated. If the change in the index represents a gain, the participation rate and cap rate are applied, determining the amount to be credited to the particular segment. If the index produces a loss, the policy guarantees the credit will never be less than 0%; that is, there will never be a negative result. If the policy's guaranteed crediting rate is more than 0%, the guaranteed rate is credited when the index is less than the guaranteed rate.

Policy Charges

- Like other universal life policies, indexed universal life policies are subject to certain charges.
- The **premium load** combines a premium expense charge and any premium tax required. This is expressed as a percentage of each premium, typically ranging from 3% to 9%. The specific percentage differs from insurer to insurer, and an insurer might charge different loads for different policies.

- The premium tax included in the load is imposed by individual states on new and renewal premiums for policies covering insureds in that particular state. Each state establishes the applicable rate, typically ranging from about 1% to 3% of gross premiums.
- The **cost of insurance** is another monthly deduction, generally expressed as a dollar amount per thousand dollars of coverage. The insured's age, gender and other underwriting data are considered to arrive at a fair rate. Cost of insurance also includes any riders that require a separate premium.
- The **expense charge** is sometimes applied to cover administrative costs separate from the premium load charges.

Policy Loans and Withdrawals

- Indexed universal life insurance policies permit loans when the cash value is sufficient.
- The policyowner is charged interest on the loan at either a fixed rate or a variable rate. A fixed rate loan usually involves an interest rate that is lower than market rates. The percentage is specified in the policy.
- Withdrawals from the cash value are typically allowed after the policy has been in force for a specified period of time. There is usually a charge for each withdrawal.
- Both the death benefit and the cash value are reduced by the amount of the withdrawal.
- If a withdrawal is made before interest is credited, no indexed earnings will be credited to the withdrawn amount.
- A surrender charge may apply if the policy is surrendered (canceled) early in the contract term. This amount is deducted from the accumulated cash value before the value is paid to the owner.

The Bottom Line

Indexed universal life insurance offers important flexibility. Policyowners have the freedom to make alterations to the policy as their life circumstances change. The indexing feature provides yet another opportunity to improve returns while guaranteeing the protections of traditional life insurance.

SUMMARY

What Is Indexed Universal Life Insurance?

Indexed universal life insurance is a form of permanent life insurance that includes features designed to make these policies more attractive to consumers. One feature is indexing, which means values in specified accounts are linked to a financial index such as the S&P 500®. This provides the potential for earning a greater rate of return. In addition, policyowners have the flexibility to adjust both the premium and the death benefit up or down throughout the insured's lifetime.

How Do Flexible Premiums Work?

There is a minimum premium necessary to keep the insurance coverage in force. However, the policyowner may choose to pay a higher premium, with the excess going into the cash value account. Once the policy has accumulated sufficient cash value, the policyowner may elect to reduce the premium or even skip one or more premium payments.

How Does the Flexible Death Benefit Work?

During the life of the policy, the policyowner may adjust the death benefit up or down with the insurer's approval. An increase in the death benefit requires that the insured is still insurable. If a higher benefit is approved, the minimum premium will also increase. A decrease also requires the insurance company's approval, although proof of insurability is not required.

What Are the Death Benefit Options?

Indexed universal life policies typically offer two or three death benefit options.

- Option A provides a level death benefit equal to the face amount of the policy, with the cash value providing part of the benefit.
- Option B provides a death benefit that increases over time because the cash value is added to the face value.
- Option C (less common) provides a death benefit equal to the face amount of the policy plus aggregate premiums paid, less any cash value distributions.

What Is the Indexing Feature?

An indexed policy is linked to a market indicator or index. The account values are not actually invested in securities, but have the potential to earn greater interest. If the index goes up, the interest credited to the account goes up. If the index goes down, the interest credited also goes down. However, no matter how poorly markets perform, the interest rate never falls below 0%. On specified dates, the interest is calculated by measuring the change in the index from one date to the next. Several methods are available to measure these changes.

Indexed policies include a participation rate—in other words, the percentage of the index gain that will actually be credited. Most indexed universal life policies have a 100% participation rate, but some insurers may specify lesser percentages. A policy may also include a cap rate—the maximum percentage increase the insurer allows, regardless of the actual gain.

What Are the Benefits?

Indexed universal life offers the safety and protection of traditional life insurance plus the potential for faster and greater growth in the cash values. Flexibility in both premium payments and death benefits lets policyowners tailor policy features to changing needs. This is possible by increasing, decreasing or skipping premiums and by increasing or decreasing the death benefit. Changes, of course, are subject to insurer approval.

Policyowners have the option to access cash values through withdrawals or policy loans when cash accumulations are sufficient.

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