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White Paper

Equity-Indexed Universal Life Insurance

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Equity-Indexed Universal Life Insurance

What is equity-indexed universal life insurance?

Equity-indexed universal life insurance (EIUL) is a form of universal life insurance, meaning it is permanent (cash value) insurance. Like universal life insurance, EIUL offers you the ability to change your level of protection, premium amounts, and payment frequency.

Both universal life (UL) and EIUL pay interest on excess premium contributions, creating a cash value. Traditional UL and EIUL both pay a minimum guaranteed interest rate on cash accumulations.

However, EIUL differs from traditional UL regarding how excess interest is determined. Typical UL insurance provides a guaranteed minimum interest rate, plus an excess interest rate when the insurance company's investments perform well. EIUL policies are different. Most EIUL policies have two separate accounts that can be used to credit interest. One account has a fixed interest rate that is declared by the insurance issuer periodically. The second account provides an equity index option that offers you the opportunity to earn rates of interest based on positive equity (stock) market returns. However, the cash value of the EIUL policy is not exposed to losses due to negative market returns.

Caution: Guarantees are subject to the claims-paying ability of the life insurance issuer.

How does EIUL work?

Combines aspects of universal and variable life insurance

EIUL combines aspects of both universal and variable life insurance. EIUL is universal life insurance since it has an interest crediting rate, and excess cash values are not exposed to the equity market as is the case with variable life insurance. However, EIUL is similar to variable life insurance because cash accumulations are based on equity market performance. Cash accumulations of variable life insurance policies are determined by the performance of the subaccounts in which your money is invested and will rise if your investments do well, or fall if your investments do poorly.

Cash accumulations of EIUL policies are determined by the performance of a stock market index. However, unlike variable life, EIUL cash accumulations are not invested in subaccounts, so they are not subject to risk of loss due to poor market returns. Instead, EIUL cash accumulations earn interest based the gains, if any, in the stock market index. Interest is credited to cash accumulations within an EIUL policy in much the same way as interest is earned in an equity-indexed annuity.

There are a number of facets within an EIUL policy which differ from traditional universal life and variable life insurance. Most of these items relate to how the interest is credited to the cash value of the EIUL policy.

The equity index

The amount of interest credited to your cash value is tied to the performance of your policy's particular equity index, so that in years where the index performs well, the interest credited to your cash value rises, whereas in years where the index performs poorly, your interest rate falls. Most EIUL policies guarantee that your interest rate will never fall below zero so that you won't lose money if the stock market index declines. EIUL policies commonly have a limit or cap on the amount of interest that is credited to your cash value. The cap on your interest earnings is applied, in part, to offset the issuer's assumption of any negative returns that may occur in the stock market index.

Issuers use different equity indexes, such as the Dow Jones Industrial Average, Lehman Brothers Bond Index, and NASDAQ, but the most common index applied is the S&P 500.

Index term

The interest credited to your cash value in the index account is determined by the gain, if any, realized over a pre-determined period of time, called the index period or term. Each index term has a beginning date (when the initial index value of the underlying equity-index is recorded) and an ending date (when the ending index value of the same index is recorded). The percentage change in the respective index values is then calculated. If there is a gain in the ending index value over the beginning index value, your cash value is credited with interest based on a portion (or all) of the percentage gain. If the beginning index value is higher than the ending index value no interest is credited, unless your policy provides for a minimum interest credit in spite of negative index returns. The length of index terms can range from one year to several years. The amount of index gain that is credited to your cash value as interest is based on the policy's participation rate.

> **Example(s):** Assume the index used in your EIUL is the S&P 500, the index term is one year beginning on March 1 (index anniversary date), and the point to point crediting method is used. Hypothetically, the value of the S&P 500 at the close of business on March 1 is 1,200 and its value on the close of business on March 1 of the following yearis 1,300. The difference in the values of the S&P 500 is about 8.3 percent (1,300 - 1,200 = 100/1,200 = 8.3). This percentage is credited to your cash value as interest, subject to the policy's participation rate and cap. Thereafter, interest continues to be calculated by comparing the value of the S&P 500 on each succeeding index anniversary date to the previous years index anniversary date.

Participation rate and cap

The participation rate determines how much of the index's gain will be used to calculate the interest rate that is applied to your cash value. Some EIUL issuers guarantee a 100 percent participation rate for the duration of the policy, while other issuers reserve the right to change the participation rate at their discretion. If the participation rate is 100 percent, then all of the gain in the equity index will be credited as interest to your cash value, subject to a cap. The cap is the maximum percentage of interest that will be applied to your cash value during any indexing period. The participation rate and cap applied by the EIUL issuer often depends, at least in part, on the type of indexing method used.

Example(s): If the equity index used in the EIUL policy gained 12 percent during the index period, and the participation rate is 90 percent, then the percentage of interest credited to your cash value is 10.8 percent (12 x .90). Furthering the example, if a cap of nine percent also applies, then the percentage interest credited to your cash value would be nine percent, not 10.8.

Indexing methods

Different index crediting methods

The index crediting method is used to measure the gain (or loss) in a stock market index within the EIUL. There are three primary index crediting methods commonly used by EIUL issuers: the annual point-to-point method, the daily averaging method, and the monthly averaging method.

Annual point-to-point method

The annual point-to-point method compares the value of the equity index at the beginning of the term to its value at the end of the term, disregarding market fluctuations in between. Each term is one year. If the ending index value is higher, interest is credited annually subject to the participation rate and cap. If the ending index value is lower, then no interest is credited, unless the policy guarantees a minimum interest credited to the cash value.

Example(s): Your EIUL policy uses the S&P 500 index, an annual point-to-point crediting method, an 80 percent participation rate, and a 12 percent cap. Your index anniversary date is June 10 of each year. Hypothetically, on the close of business on June 10, of last year, the value of the S&P 500 was 1,250 and on the close of business on June 10 of this year, the value is 1,350. Since the S&P 500 index increased in value from June 10 of last year to June 10 of this year, interest will be credited to your cash value based on the following calculation: 1,350 - 1,250 = 100/1,250 = 8 percent x 80 percent participation = 6.4 percent. Since 6.4 percent is less than the 12 percent cap, the entire 6.4 percent interest is credited to your cash value for the year. Note that any changes or fluctuations in the S&P 500 during the index period (one year) are not considered, only the values on the beginning and ending dates are used.

Daily averaging method

The daily averaging method takes the average daily index value over the entire index term and compares this average to the beginning index value on the first day of the index term. Most index terms are one year. If the average daily index value over the entire index term is greater than the beginning index value, interest is credited subject to any applicable participation rate and cap.

Example(s): Use the same information as in the previous example, except that the index method is daily averaging instead of annual point-to-point. Beginning on the close of business on June 10 of last year, the S&P 500 value is recorded at the close of each business day between June 10 of last year and June 10 of next year. These values are added together then divided by the number of days calculated. Presume the daily average value is 1,320. This value is compared to the beginning value of the index on June 10 of last year (1,250) and the same calculation as is used in the annual point-to-point method is used for the daily averaging method: 1,320 - 1,250 = 70/1,250 = 5.6 percent x 80 percent participation = 4.49 percent, which is the percentage of interest credited to your cash value for the year.

Monthly averaging method

The monthly averaging method is similar to the daily averaging method except that the index value is recorded on a particular date of each month (such as the 23rd), usually for 12 consecutive months. The average of each of the 12 monthly values is then compared to the beginning index value on the first day of the index term. If the average index value over the entire index term is greater than the beginning index value, interest is credited subject to the participation rate and cap if applicable.

Example(s): Again, use the same information as in the previous examples, except that the index method is monthly averaging. Beginning on the close of business on June 10 of last year, the S&P 500 value is recorded at the close of business on the 10th of each month or the next closest business day, until June 10 of next year. These values are added together then divided by the number of months calculated (in this example, 12). Presume the monthly average value is 1,440. This value is compared to the beginning value of the index on June 10 of last year (1,250) and the same calculation as is used in the annual point-to-point method is employed: 1,440 - 1,250 = 190/1,250 = 15.2 percent x 80 percent participation = 12.16 percent. Since 12.16 is greater than the cap of 12, only 12 percent interest is credited to your cash value.

EIUL features similar to traditional universal life insurance

Permanent (cash value) life insurance

Both EIUL and UL are permanent (cash value) insurance. Each type of insurance usually credits your cash value with a guaranteed minimum interest rate plus an excess interest rate. EIUL and UL also offer you flexibility through the ability to change your level of protection, premium amounts, and payment frequency. In this way, your policy can keep pace with changes in your life and your corresponding insurance needs.

The policies' cash values can be accessed by you during your lifetime. Cash values of each type of policy grow tax deferred.

Caution: Guarantees are subject to the claims-paying ability of the life insurance issuer.

You can change your premium payments

Generally, each policy allows you to increase, decrease, and even skip premiums after the first policy year, as long as the cash value is large enough to cover policy expense charges. You have the ability to change the amount or frequency of your premium payment without giving the insurer prior notice. Most EIUL and UL issuers suggest a target premium amount to keep the policy in force.

> **Caution:** If your cash value isn't sufficient to cover the current expense and mortality charges, you may be required to make an additional premium payment in order to prevent a policy lapse.

Policy loans

As cash value life insurance, both EIUL and UL insurance allow you to borrow from cash surrender values using a policy loan. Policy loans are allowed under the terms of your insurance contract. Loan interest is charged on any amount of cash value borrowed that is not considered a withdrawal. The interest rate on a policy loan is declared by the policy issuer in advance.

> **Caution:** If you die with an outstanding policy loan against your account, your death benefit is reduced by the amount of the outstanding loan balance.

Guaranteed death benefit

Like most UL insurance, some EIUL policies offer a guaranteed death benefit. The insurance company guarantees that as long as a minimum premium is paid on time the coverage will not lapse. The minimum death benefit guarantee may last the first five policy years or longer. If the lifetime death benefit guarantee option is selected, the coverage can never be terminated by the insurance company as long as the policy premium is paid when due, regardless of equity-indexed or UL interest performance. Usually there is an additional cost for the lifetime guarantee which reduces your policy’s cash value growth potential.

EIUL Disadvantages

One disadvantage of equity-indexed universal life insurance is the potential for little or no gain in cash values during periods of negative stock market returns compared to minimum interest guarantees of universal life insurance. Also, the interest rate cap limits the upside potential compared to the unlimited growth potential of variable life insurance. EIUL has more “moving parts” than either universal or variable life such as caps, participation rates, and crediting methods which can be confusing. Also, policy surrender charges decrease your cash values if you decide to surrender the policy prior to the end of the surrender period.

Another disadvantage of UL also applies to EIUL. The cost of insurance, along with other fees and charges, reduces your policy's cash value. In addition, the cost of insurance will increase each year as your (the insured) age increases. If you choose to reduce or skip premiums, it is possible that your cash value may not be sufficient to cover the cost of insurance increases over time.

When you take a policy loan, the loan proceeds you receive come from the general fund of the insurance company. The loan amount is not actually withdrawn from your cash value account. However, an amount of your cash value equal to the loan amount is marked as collateral for the loan. The collateral amount usually is credited with a lower interest rate than the remaining cash value. The reduced interest credited to a portion of your cash value will slow the growth of your cash value. Also, unpaid loans will reduce the death benefit payable to your survivors.

Is EIUL right for you?

EIUL may be the right choice for your life insurance needs if:

- You need permanent cash value life insurance.
- You want the flexibility of changing the policy death benefit, timing, and amount of premium payments.
- You intend to keep the policy for a long term (at least ten years). EIUL can be an important financial planning tool that not only provides your beneficiary with a death benefit, but also contains cash values that can be accessed during your lifetime to help meet financial goals or needs.
- You like the potential of cash accumulation found in variable life insurance but you don't like the risk of loss associated with investing in the equity market.
- Guaranteed interest accumulation is appealing to you, but you want the potential for higher rates of return than those paid by traditional universal life insurance.

If these factors appeal to you, then an EIUL policy may be the right choice for your life insurance needs. Before deciding on a particular insurance product, be sure to research the company behind it. The amount of interest you are credited and whatever guarantees the product offers are only as solid as the company offering them.

Disclosures

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