SOCIETY OF ACTUARIES

Article from:

Product Development News

August 2005 – Issue 62

Features

Equity-Indexed Universal Life

"The Devil's in the Details"

by David J. Weinsier

Equity-indexed universal life (EIUL), while having existed since 1997, appears to finally be in a position to cause a legitimate wave in the marketplace. Carriers looking to capitalize on the recent surge of equity-indexed annuity sales (EIA) are poised to enter the EIUL market. Low interest rates and choppy equity markets, along with consumer jitters that continue to cast a cloud over the variable markets ever since the stock market bubble burst five years ago, make for near-perfect economic conditions for equity-indexed products.

The EIA market has shown that a product featuring potential upside accumulation indexed to the equity markets, combined with downside protection, can carry plenty of appeal in the eyes of the consumer. Of course, it should be acknowledged that relatively high compensation has also been a contributing factor to healthy EIA production figures.

Despite relatively low sales to date (Exhibit 1), many believe the EIUL market is well positioned to follow the same upward sales trend experienced by EIAs, thus increasing market share amongst current life stalwarts (Exhibit 2). Currently the EIUL market is dominated primarily by one carrier with several others trying gain market share. There is reason to believe that several major players will be entering this marketplace by the end of 2005, potentially changing the competitive landscape of this product. Those poised to enter the market typically come from one the following pedigrees.

1. VUL carriers

Some VUL carriers are looking to move into alternate distribution channels. As EIUL products are non-registered, they do not typically compete with VUL distribution. A VUL carrier looking to expand sales can enter this space while likely avoiding significant channel conflict and taking sales away from their "bread-and-butter" product line. The primary hurdle to entering the EIUL market may be an administrative system that must be overhauled to accommodate such a product.

2. EIA players

EIA players wish to leverage their product knowledge and hedging capabilities to gain efficiencies on the life side. While both of these factors give them a head start to success, the additional moving parts and required capabilities required for a life product (e.g., need for sales illustrations) can lead to bumps in the road on the way to market entry. It is also worth noting that annuity-oriented distribution systems have historically experienced challenges selling life product.

3. UL sellers

Companies that derive most of their sales from general account UL, a close cousin to EIUL, may be best positioned in terms of speed to market due to many of the required

administrative capabilities already having been set up. Of course, tracking the equity markets, setting up hedging capabilities, and training agents on a new concept can take time, effort and care.

When appointed to bring an EIUL product from concept phase to market roll-out, several unexpected challenges specific to this product have a tendency to rise up along the way. In this article, we will examine decisions that must be made during the design phase, introducing common hurdles that tend to develop, as well as questions that must be answered.

The key to product design is to achieve a reasonable balance between product complexity and the availability of value-added options. Representation from your product implementation team should be involved early in the design stage so that administrative capabilities are fully understood and features aren't promised which are particularly troublesome to implement. The following policy features and methodologies must be defined while always keeping the aforementioned balance in mind.

Method of Crediting
Virtually all EIUL products available today use an annual reset (i.e., ratchet) structure. Index interest can be credited on a point-to-point basis or via an averaging formula. The former is simpler to administer and understand from an agent/policyholder perspective, but the latter will allow for a higher participation rate or cap.

Participation Rate
Recently most carriers have moved to offering a 100 percent guaranteed participation rate. While those involved in product development realize that the participation rate simply serves as a balancing item between the option budget and cost of the comparable index option needed to hedge the liability, many agents and policyholders continue to hold the perception that a participation rate of, say 75 percent, implies the carrier retains 25 percent of the index gain as profit. While initial players in this space made failed attempts to explain this concept to agents and policyholders, companies today have realized that the 100 percent participation rate makes the most sense, and instead allow an alternative feature (e.g., the index cap) to change along with derivative costs.

Index Cap
As mentioned above, the cap has become the primary "moving part" when pricing EIUL. A minimum cap is defined in the contract while the carrier sets a current cap at issue and reserves the right to reset the cap, typically once per anniversary. While an annual cap has served as the standard to date, a recent trend in the EIA market is to offer a monthly cap (e.g., 3 percent per month), allowing the (unlikely) possibility of a 36 percent annual return, which far exceeds the typical 12 to 15 percent annual cap. It also should be noted that some state regulators have frowned upon policy designs featuring both a non-guaranteed participation rate and cap. Thus most products define one as guaranteed (typically the 100 percent participation rate) and allow themselves to adjust the other to fall in line with current derivative costs.

The key to product design is to achieve a reasonable balance between product complexity and the availability of value-added options.

Guaranteed Rate
Guaranteed rates in the marketplace generally range from 1 to 3 percent per annum. A leading seller of EIUL features a 2 percent *cumulative* guarantee over a five-year indexing period. This implies that the index gains would have to return less than a cumulative 10 percent return at the end of five years in order for the guarantee to be in the money. Such a feature can result in lowering the cost of the guarantee, thus providing a larger option budget than an equivalent product with an annual guarantee.

continued on page 10

Exhibit 1

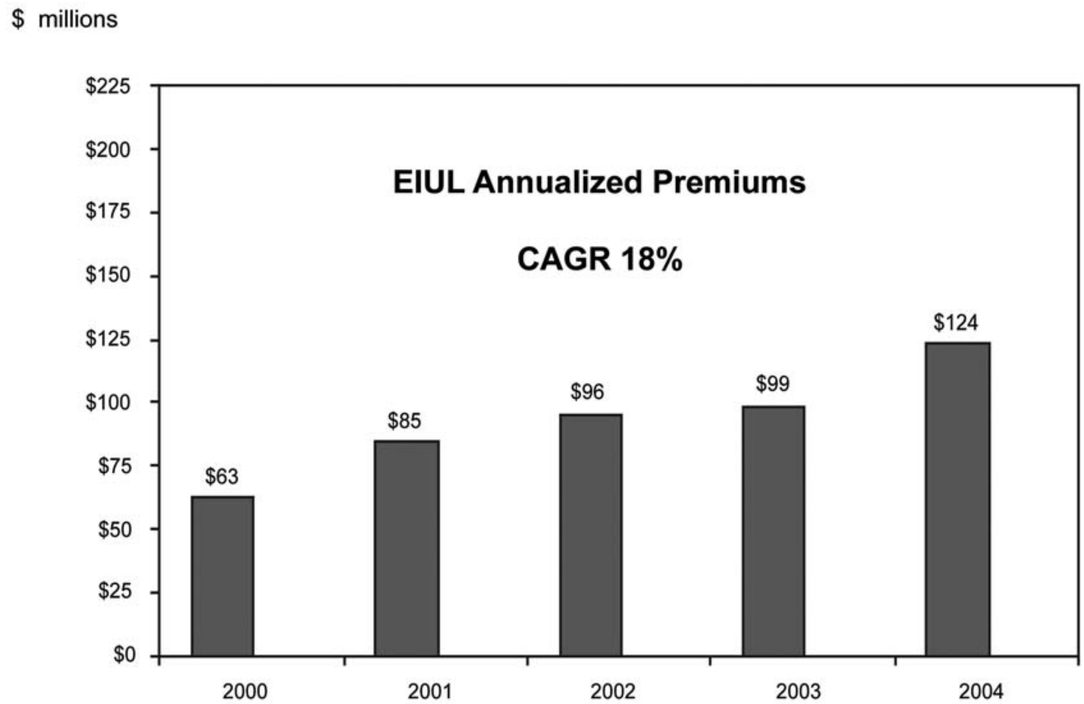
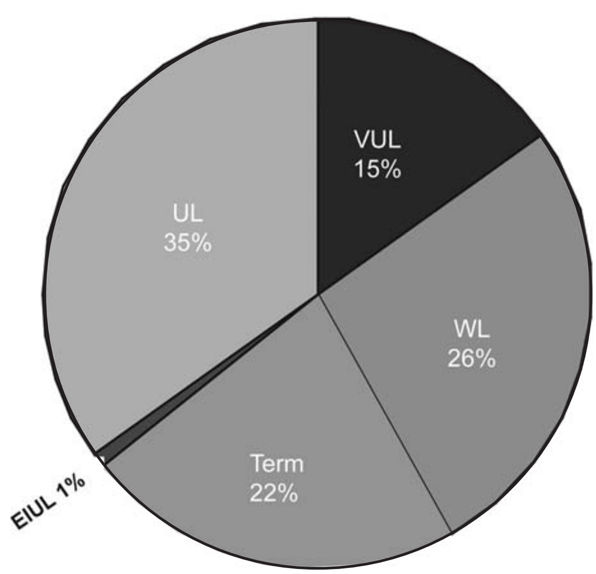


Exhibit 2

2004 Life Market Share Based on Sales



Source: LIMRA

Index
While the S&P 500 has historically been the index of choice for equity-indexed products (primarily due to the viable option market), some EIA products offer policyholders the option to participate in alternative indices. It is expected that EIUL carriers, particularly those able to leverage off such a feature as part of their EIA portfolio, will follow suit.

Timing of Transactions
A decision must be made as to how many indexed buckets will be established. In other words, how frequently will a policyholder's premium be transferred to the indexed account? Annually, quarterly, monthly, bi-monthly and daily can all be found in the marketplace. Allowing for frequent transfers can carry more marketing appeal and may keep you from having to establish a short-term fixed account to hold premium prior to the next transfer date. Less frequent transfers leads to better matched hedging.

Some plans base index segments on policy dates (e.g., monthaversaries) while others are based on calendar dates (e.g., 15th of each month). The former typically favors the policyholder, especially when premium is paid on a consistent date, while the latter allows for a better matched hedge for the carrier, due to the fact all policies' premiums can be swept into one pool to be hedged.

Fixed Account
Due to its sales appeal, offering the policyholder the ability to apply a portion of each premium into a fixed (i.e., non-indexed) account within an EIUL product has become a "must-have" feature. Unfortunately for the actuary and product implementation team, this feature does introduce some unique challenges, the degree of which depends at least partially on answers to the following questions:

- Will fund transfers be allowed between the fixed and indexed accounts? If so, how frequently (warning: unlimited transfers could lead to anti-selection, as well as leaving you over or under hedged)?
- How will monthly charges be deducted? Will they be taken only from the fixed account or from both the fixed and indexed account based on fund value? Will charges be deducted from each bucket on a pro rata basis, or LIFO, based on the bucket in which the last premium was applied to?
- Interest on the fixed account is typically credited on a monthly basis. Will interest in the indexed account, which is credited annually based on index gains, be based on average fund value over the indexing period or fund value just prior to the bucket anniversary?
- From which account will loans and withdrawals be deducted?

It is my experience that while the questions above are far from top of mind during the initial design stage, many a project plan has experienced significant delays due to the administrative complexities they can bring about.

No Lapse Guarantee
Due to the recent surge of sales of general account UL products featuring lifetime NLGs, some carriers have decided to include such a feature on their EIUL products as well. The upside of additional sales brought on due to the appeal of this feature needs to be weighed against the following:

- Is this feature appropriate on a product typically used for accumulation, as opposed to protection?
- The cost of the feature attached to an EIUL is higher than a UL product due to the lower guaranteed rate.
- How will index credits be applied when the fund value falls below zero?
- How will reserves be impacted?

Summary

Due to the surge in sales of both EIAs and UL products in recent years, it is anticipated that many more companies and products will infiltrate the EIUL marketplace by the end of 2005. This means we should anticipate innovative product designs and increased competition in the near future. Those carriers that can most quickly answer the questions and avoid the speed bumps raised above will improve their speed to market and have a leg up on their competition. ☐

David J. Weinsier, FSA, MAAA, is a senior consultant with Towers Perrin in Atlanta, Ga. He can be reached at David.Weinsier@towersperrin.com.