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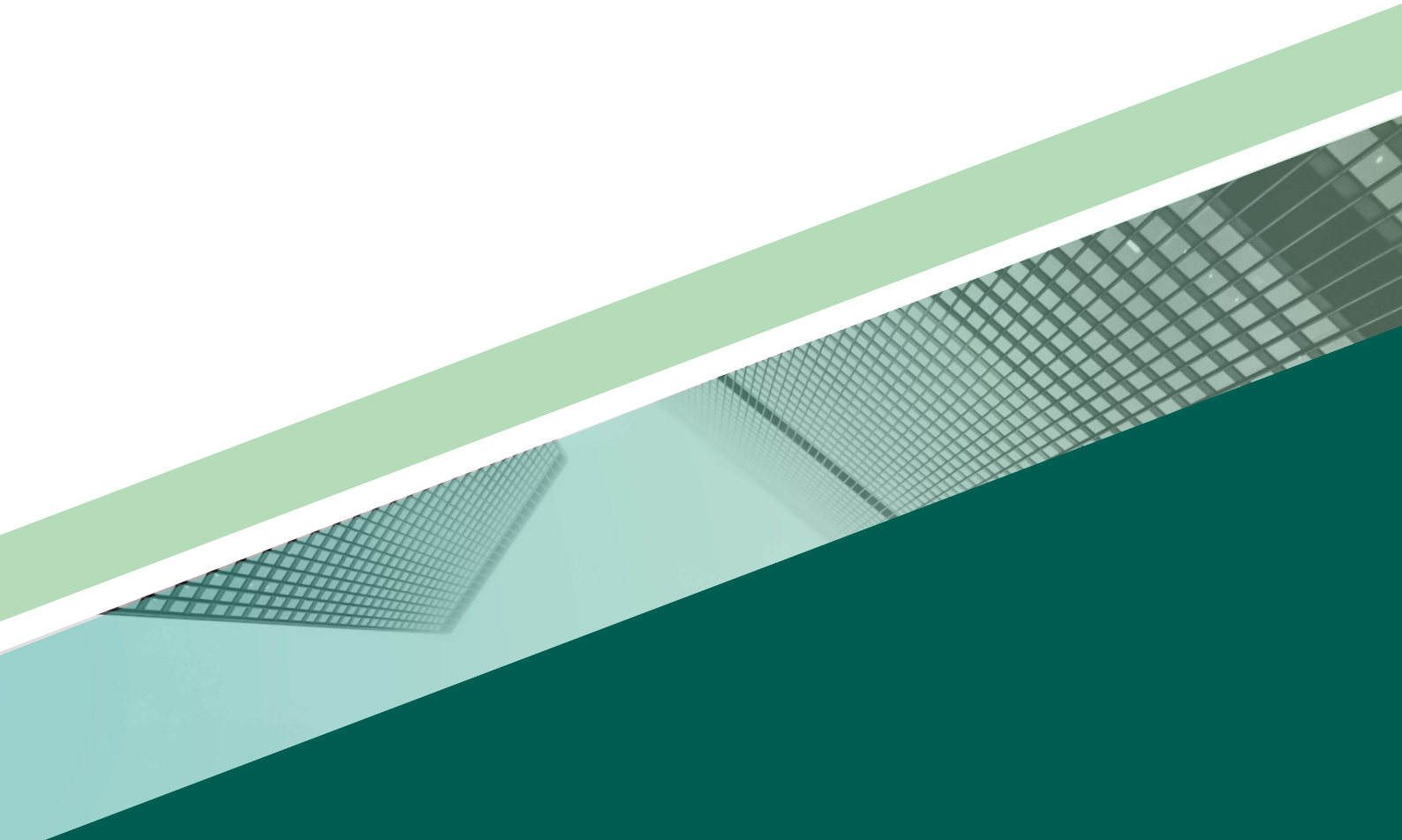

Why Indexed Universal Life Is Attractive (and Detrimental) for Executive Retirement Plans

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Supplemental Executive Retirement Plans based on Indexed Universal Life insurance have overpromised and underdelivered.

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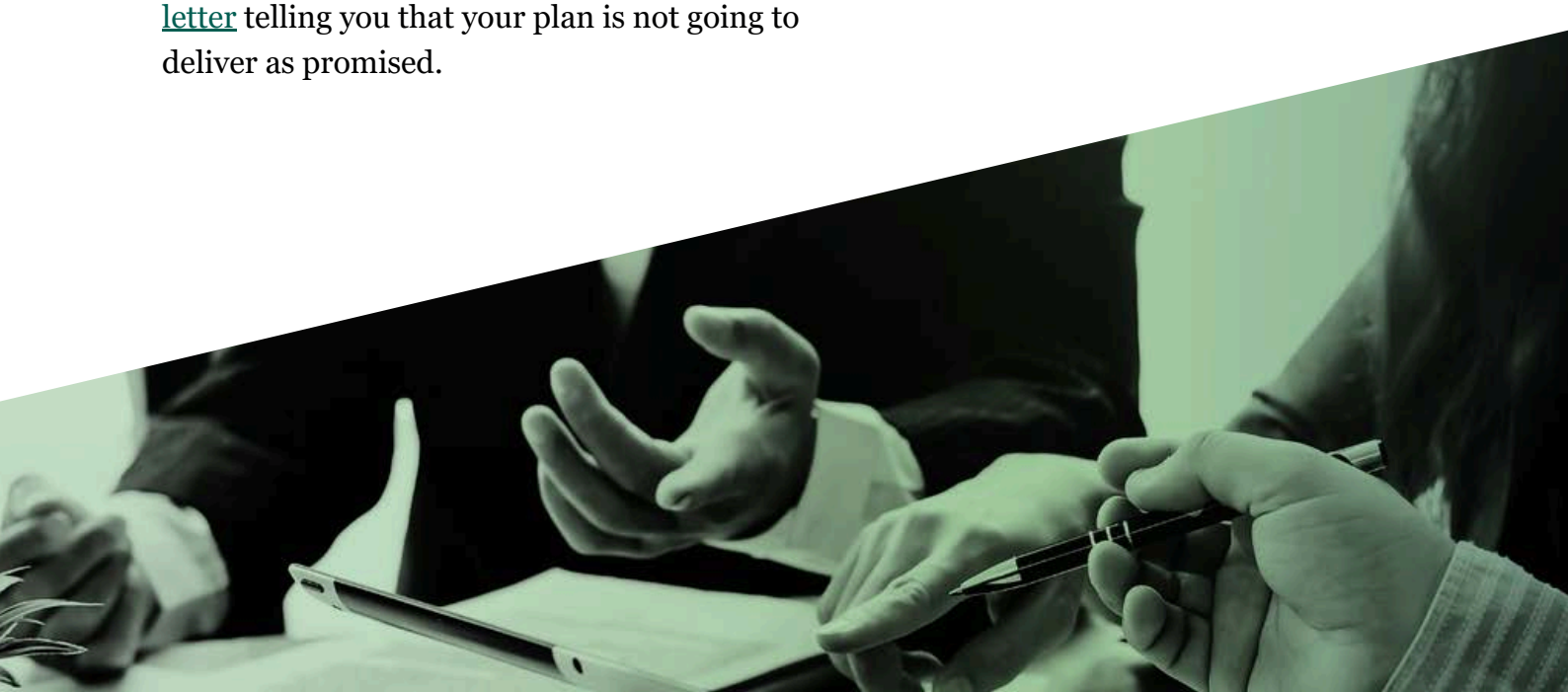
Indexed Universal Life (IUL) insurance sounds like an executive's retirement funding dream: a financial product with flexible premiums, the potential for market-linked growth, and a safety net for retirement. But when Indexed Universal Life is the foundation of your executive retirement plan, it may be a siren song—beautiful on the surface, but hiding dangerous rocks you'd really rather avoid.

In this article, we'll examine characteristics of IUL that are subtle yet significantly problematic, especially when used for loan regime split-dollar Supplemental Executive Retirement Plans (SERPs). The dangerous rocks of IUL SERPs include the way caps work and sequence of returns risk or the "luck factor."

We'll also look at ways to manage the risk of having a SERP so you can more appropriately project your retirement benefit and avoid getting a bad news letter telling you that your plan is not going to deliver as promised.



Why What You See Now Might Not Be What You Get Later

When consultants come to your credit union to talk with you about life insurance-based SERPs, they'll often suggest using IUL as the foundation for your plan because of its "upside potential and downside protection." They'll say that the policy has a "zero floor, so you can't lose money when the market goes down."

Then they'll present an illustration[1] with an illustrated rate for the performance of the IUL policy they hope you'll buy. If you already own such a policy, you probably remember this presentation.

While these statements are true on the surface, they can be something of a siren song—beautiful, until you look deeper and find the rocks hiding under the seemingly still water.

IUL-based SERPs are designed for upside potential and downside protection, but as we'll see later in this article, they may still have years of unacceptably poor performance.

The floor on these policies is typically zero. But policy charges and bad luck with risks like sequence of returns, which we'll get into shortly, might still put your policy underwater in tough market years.

The illustrated rate used in the illustration of the potential growth of the policy's cash value and benefits is hypothetical. Importantly, it is not a guaranteed rate, but an illustration of how the policy might perform under certain conditions, based on certain assumptions.

For finance people like us, the fact that an IUL illustration carries phrases like "not a guaranteed rate," "how the policy might perform," "under certain conditions," and "based on certain assumptions" raises a lot of red flags for an insurance product you're going to rely on for some or all of your retirement income.

[1] A life insurance illustration is a document provided by an insurance company that shows how a life insurance policy is expected to perform under different scenarios. It's a hypothetical projection, not a guarantee, of how the policy's cash value and death benefit might change over time, based on various assumptions.

Let's review several key IUL concepts to help lay the foundation for a deeper discussion of how the illustrated rate for an IUL is established. We'll start with the actual annual policy credit as a lead-in to covering caps, a critical element in the success or failure of IUL-based SERPs.

Crediting Rate: How Much Can You Really Expect in Retirement?

Strict rules dictate how the performance of IUL policies is illustrated. The maximum allowed crediting rate of return that can be used at any time by the insurance company is based on actuarial guidelines (AG 49) from the National Association of Insurance Commissioners (NAIC), which sets standards and best practices for the industry.

The actual performance of an IUL policy comes from the actual annual policy credit, as opposed to the illustrated credit. This actual policy credit determines the earnings credited to the policy's cash value in a year. Unlike the illustrated projected credit, the annual policy credit is a key determining factor of the actual benefit you'll get when you retire.

The annual policy credit—your upside for owning the policy—is determined by the cap set by the insurance company and the actual performance of the underlying market index. The policy credit could be zero if the index has a negative year.

The 'Cap' Conundrum

With an IUL-based SERP, the insurance company sets the annual cap, or limit, on what the plan can earn, tying it to an underlying index like the S&P 500. For a principal amount of $100,000 with a cap of 8%, for example, the "policy credit" to the plan is limited to $8,000—even if the underlying index is up 25%. We want to stress that the cap determines the true performance of an IUL, not how well the underlying index performs.

While the cap on its own is a limitation on your upside, a deeper issue is that insurance companies have consistently lowered their caps over the last 15+ years, resulting in a material reduction in upside potential for existing policy owners.

The key components that determine the caps are interest rates and options pricing.

Interest Rates

To give IUL policyholders upside potential and protect their downside, the insurance company executes an options strategy, simultaneously buying and selling options. Interest rates determine the insurance company's "options budget," essentially what the insurance company has to spend when executing the options strategy.

The options budget is determined by the yield on the insurance company's general account, which you can think of as the holding account for premiums the company receives on all the products it sells. To be clear: lower interest rates = lower yield on the general account = lower options budget.

Options Pricing

Executing an options strategy has become more expensive for insurance companies over the last 15+ years because of key market trends.

When these types of products were introduced approximately 15 years ago, option pricing was low due to inefficiencies that are normal in a new market. Over the years, option prices have increased as the market has become more efficient, due to the popularity of index-based products, such as IULs and indexed annuities.

More expensive options and less money with which to buy them is the worst-case scenario. This combination is what has driven down caps over the last 15+ years. Insurance companies have been forced to reduce caps to maintain their profitability in this environment. While caps were approximately 13% a decade ago, they hover around 8% today.

In recent years, virtually all insurance companies have also “de-linked,” creating separate blocks of policies, each block with a different cap based on when the policies were purchased. This strategy allows newly introduced policies to illustrate much better because they are benefiting from the rise in interest rates that results in a higher options budget.

In other words, executives buying new IUL policies today get higher caps based on the recent rise in interest rates. IULs sold seven years ago might have an 8% cap, while IULs sold today might have a 10% cap.

Policies in the earlier blocks have lower caps and can’t immediately benefit from the rise in interest rates. The bonds in the general account associated with the older blocks need to mature and get reinvested at higher rates. This can take 15-20 years.

Notably, today’s new policyholders might eventually be part of an “older” block and have their plans’ potential limited by the cap assigned to that block.

How Are the Maximum Illustrated Rates Determined?

As a reminder, an illustration of an IUL-based SERP is a hypothetical projection of the potential growth of the policy's cash value and benefits over a given number of years. This illustrated rate is always a constant rate of return with no variability.

Let's dig into more detail about how an illustrated rate is determined:

- An assumption is made that the cap and the floor will never change. However, we've explained in this article how the cap can and does change!
- The cap and the floor are applied to annual historical index return data, such as the performance of the S&P 500.
- Insurance companies then calculate the geometric mean across thousands of 25-year time blocks going back 66 years using that cap and floor. The illustrated rate is the average return from all these blocks.

When you use an average like this, slightly over half of the actual outcomes will be above the average, and slightly less than half will be below the average. Importantly, about a quarter will be way above the average, and similarly, a quarter will be way below the average.

Before buying an IUL-based SERP, it's really important to know that both of these outcomes are entirely possible. Does your plan work if it falls into one of the "way below" average scenarios? It really doesn't.

We've now shown how the risks associated with caps make building SERPs with an IUL significantly problematic. And we haven't yet discussed another important risk factor associated with IUL SERPs: sequence of returns risk.

The Luck Factor: Sequence of Returns Risk

Another massive rock hiding under the IUL SERP water is “sequence of returns” risk—the impact of the timing of gains, losses, and withdrawals within the plan policy.

Essentially, although average returns can have an impact on an IUL used for a SERP, they do not matter anywhere near as much as the sequence of those returns.

Let’s say that again, since almost everyone focuses on average returns when investing. If you’re using an IUL as the basis for a SERP, the average return on the underlying index has dramatically less impact on success than the sequence of returns. This is “the luck factor.”

During the accumulation phase—when you’re putting money in—the average return matters. But the real danger comes during the distribution phase—when you're ready to withdraw money for retirement. That’s when the sequence of returns is really what matters.

If the market performs poorly at the wrong times, the plan and your retirement benefit are in serious trouble. We can’t stress enough that while the zero floor of an IUL policy protects the policyholder from market declines, the plan will experience policy costs or charges that will drive down cash values during a negative year in the market. Each withdrawal during a year with a zero-annual policy credit depletes your cash value faster, creating a death spiral for your retirement savings. This is one of the key reasons the sequence of returns is so important.

Interestingly, sequence of returns risk impacts your plan from point to point, so the anniversary month of your plan may actually have an adverse impact on your retirement benefit.

At PARC, we incorporate Monte Carlo[2] simulations to take sequence of returns risk into consideration. When designing with the maximum illustrated crediting rate incorporating sequence of returns risk, our analysis shows declines of between 30% and 50% in the projected benefit. And our analysis of older plans, which take into account the declines in caps and sequence of returns risk, can show a reduction of the projected benefit of as much as 80%. That means that if you thought you were getting $500,000 a year in retirement, you would actually get $100,000. How does anyone plan for their retirement with this kind of risk?

We think if more executives and boards understood the risk associated with caps and sequence of returns, they would structure their SERPs like we do—using whole life insurance from a mutual insurance company that treats all policyholders the same, no matter when the policy was purchased. Stay tuned for an article on the benefits of using whole life insurance for a SERP.

[2] A Monte Carlo simulation is a computational technique that uses repeated random sampling to model the probability of different outcomes in a process that involves uncertainty. Essentially, they help to understand the range of possible results for a situation by running many simulations with slightly different inputs.

Managing the Risk

We recommend two ways to manage the risk of IUL-based SERPs.

Look at Whole Life Options

Many of the risks we've highlighted about IULs are also present with whole life, but to a dramatically lesser extent. When you set up a SERP based on whole life insurance from a mutual insurance company, you get a relatively stable dividend[3] based on the insurance company's profitability.

The decline in interest rates that pushed insurance companies to reduce IUL caps over the last 10 years also resulted in declining dividends on whole life, but not nearly to the same extent as the decline in IUL caps. In fact, since 2015, whole life dividends from the major mutual insurance companies have only declined about 4%, while IUL caps have declined approximately 40%.

And, even better, all policyholders are treated the same at a mutual insurance company, no matter when the policy was purchased, with everyone benefiting from the recent rise in rates. The returns for whole life might not be spectacular, but they're predictable. At PARC, we also build a downside buffer into each of our whole life-based SERPs, planning for potential declines in the dividend. Our goal is to underpromise and overdeliver.

Give an IUL-Based Plan a "Haircut"

In all your retirement planning, a conservative strategy may help ensure your benefit comes to you as planned. If you must do an IUL-based SERP, or already have one, we recommend using a very conservative illustrated rate—at least a 30% haircut from what is allowed. As an example, a 10% cap might have a maximum illustrated crediting rate of 6%. To simulate the sequence of returns risk, design the plan with a 4.2% crediting rate or lower. This haircut will make your plan more durable—that is, more likely to retain its value over time. Even using this conservative crediting rate doesn't take into account the risk associated with the cap declining over time.

Now you can start to understand why we don't utilize IULs for SERPs.

[3] Dividends are not guaranteed.

The Bottom Line

For executives and board members looking at SERPs, the message is clear: approach IULs with extreme caution because what looks like a sophisticated financial tool is actually very risky and can have unacceptable outcomes, resulting in much lower retirement benefits than you had planned.

Your retirement deserves the best planning possible. We're ready to help you sort through the options.

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About the Author

After more than 10 years specializing in split-dollar Supplemental Executive Retirement Plans at OM Financial Group, Bruce D. Smith, CFA, co-founded PARC Street Partners, a member of PARC Street Group, with Chris Jones. Bruce brings more than four decades of experience in financial services and prides himself on radical responsiveness and exceptional service.

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Bruce and Chris have implemented more than 200 split-dollar plans in the credit union and non-profit industry since 2014. Virtually every plan they've implemented is on target to deliver the original benefit at retirement and, in many cases, more than projected. This is due to their conservative nature, careful analysis, thoughtful plan design, and use of whole life insurance from mutual companies.

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Your credit union can't compete for top talent with stock options. But you can compete with something better. Our SERPs are built for credit unions that want to win the talent war without rolling the dice. Here’s the bottom line: every plan we implement meets or exceeds its original projections, period.

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