Savings-Oriented Life Insurance: Comparing Indexed Universal Life and Dividends-Paying Whole Life

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With the increasing popularity of Indexed Universal Life (IUL)[1], a number of Whole Life advocates have published material regarding IUL that can be confusing, misleading and, in some cases, factually incorrect. The purpose of this paper is to evaluate the pros and cons of using either IUL or Whole Life to fund a savings-oriented life insurance policy.[2]

Universal Life was developed in the early 1980s as a response to consumer demand for three updates to the basic life insurance product: increased transparency, separation of the pure death benefit component from the savings element, and enhanced flexibility. Essentially, Universal Life advocates worked to modernize the dividends-paying whole life products. To meet continued consumer demand, in the late 1990s an indexed version of Universal Life was developed to further enhance consumer choice and flexibility by expanding how interest is credited to the policy.

Whole Life products work as follows: The insurance company has the policyholder pay a premium to initiate the policy. This initial premium is high enough to reflect two assumptions: the maximum mortality and expense charges, and the minimum credited interest rate that the company estimates it will need in a "worst case scenario." Over the years, the insurance company's actuaries determine actual experience and make annual adjustments to the initial premiums through the declaration of annual dividends. It is similar in concept to over-withholding for taxes every year and then getting a refund once your actual tax bill is known. Through dividends, policy holders are getting credit for the amount of over payment initially charged.

IUL works in a more direct fashion. Interest credits are determined based on a defined formula tied to an outside index ***(typically the S&P 500® Index[3])***. Annual expense and mortality charges are fully disclosed each year. Policyholders can see the interest credited and the expenses deducted from their accounts. The policy states maximum expense and mortality charges and minimum credited interest rates, as required by regulation. Unlike Whole Life policies, which assume these maximum and minimum rates in the premium calculation, an IUL policy does not explicitly charge these rates up front. In IUL, these maximum and minimum rates are only used if future experience warrants adjustments.

When evaluating Whole Life and IUL, it is important to consider several factors:

1. Financial Ratings of the Carrier.

Any life insurance policy is, by its nature, a long-term financial instrument. Care should be taken to utilize only sound, highly-rated insurers.

This is true regardless of the product type used. In general, companies with an A. M. Best rating in the "A" category are preferable.

2. Transparency of Interest Credits, and Expense and Mortality Charges.

Transparency is a feature that varies widely between IUL and Whole Life. Under IUL, credits and charges are explicitly disclosed, and can be reviewed in the policy illustration. Conversely, the credits and charges under Whole Life are included in the dividend calculation and are not itemized separately. Policyholders can obtain a more transparent accounting of interest credits, expenses and mortality charges in IUL.

3. Emphasis of Savings Versus Death Benefit Component.

In today's market, the biggest use of life insurance is to accumulate savings tax free while delivering a death benefit. The IRS has a set of rules that specify the minimum death benefit component

that will allow the policy to qualify for tax free treatment. In order to maximize the savings component growth under IUL, the policy is typically structured to keep the death benefit at the IRS minimum. This, in turn, minimizes mortality charges, which allows more of the interest credited to remain in the account value. Conversely, Whole Life policies are often structured so that dividends are used to buy paid-up additions to the death benefit. This uses the credited interest to increase the death benefit value of the policy. In other words, the Whole Life policy often builds up greater death benefits at the expense of the savings component. It is important to determine if this is the objective of the client.

4. Maximum Expenses and Mortality Charges.

IUL policies state the maximum expense and mortality charges and minimum interest credits they could use. However, under normal circumstances these maximum and minimum rates are not applied: they are there to protect the solvency of the insurer and their policyholders if future experience does not prove as favorable as expected. The Whole Life policy does the opposite. It charges the maximum premium up front, and then adjusts downward via dividends based on favorable future experience. In the case of IUL, the current charges and credits are not guaranteed. In the case of Whole Life, the dividends are not guaranteed. From an actuarial standpoint, these two approaches both aim to give the insurance company flexibility as market experience changes.

5. Interest Crediting.

Perhaps the biggest innovation IUL introduced to the market place is the use of an outside index to credit interest to the policy. Typically, the S&P 500® Index is used, subject to an annual floor and cap. Through indexing, policy holders access three unique features as interest is credited. First, the credited rate can never be less than zero, so the interest credited is always zero or positive. Second, since there is a floor of zero interest credited, policy holders never give back past credits through negative credited interest. Third, because the index is reset every year, policy holders do not need to recover from the market's previous high in order to get future credits. This provides the opportunity for attractive crediting pattern, even when the stock market is volatile. Under Whole Life, the insurer's overall investment experience is embedded in the dividend scale. In years when experience is good, dividends are favorably impacted and may be higher. In years when results are not as good ***(e.g. when interest rates are low, credit losses are high, etc.)***, dividends are negatively impacted and may be lower. The interest credited in a Whole Life policy is tied to internal carrier decisions, whereas the interest credited in IUL is tied to the movement of an outside index.

6. The Impact of Expense Loadings.

Expenses are another area where transparency varies widely between IUL and Whole Life. With IUL, it is possible to show not only annual expense charges, but, more importantly, how these expenses relate to the average cash value growth over long periods of time. In an IUL policy, it can be demonstrated by the average mortality and expense charges and their impact on the growth of the cash value. It is then up to the policyholder to judge whether these overall loadings are attractive. Under Whole Life, policy holders cannot determine expense charges independently, as they are included in the dividend scale and the premiums initially charged. This makes it more challenging in a Whole Life policy to understand the impact of the expenses being charged against the policy on the policy's growth.

Overall, IUL and Whole Life use different approaches to delivering value to their policyholders. IUL brings value through transparency, indexed crediting, and direct accounting of costs in the policy. Whole Life brings value through annual dividends, which policy holders must understand serve as the connection between the premiums charged and the "experience adjusted" costs of administering the policy. Whole Life tends to generate higher death benefits at the expense of savings growth when it uses the dividend to fund paid up additions, whereas IUL tends to favor cash value growth while keeping death benefits closer to IRS minimums. As with any insurance or financial product, the needs of the client will determine which approach is best for him.