North American Company
for Life and Health Insurance
Since 1886
Life

Indexed Universal Life Insurance

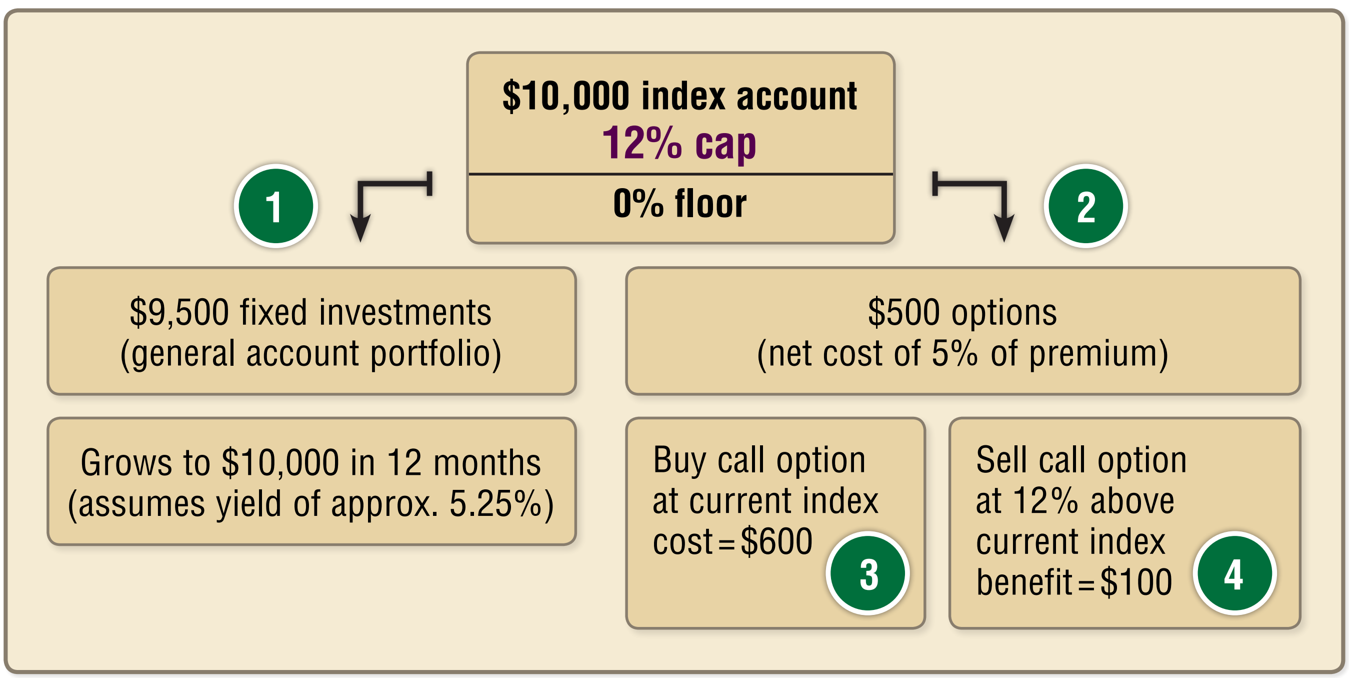
Index Account Mechanics

Have you ever wondered how an insurance company creates the zero percent floor, or determines the index cap rate? Let's take a look under the hood.

The insurance company makes investments with the premium that policyowners pay. For simplicity, this example will examine the first premium paid at issue on an IUL policy. We'll assume that the policyowner has elected an annual point to point crediting method based upon a stock market index and that $10,000 of the premium is going into the index account.

1. The insurance company invests approximately $9,500 of the premium into fixed investments such as high-grade corporate bonds that become a part of the insurance company's general account. In this example, we will assume the general account portfolio as a whole is yielding a bit over 5%. This amount will grow to $10,000 in one year, guaranteeing the index account's floor rate.
2. The insurance company uses the remaining $500 of premium to purchase a "bull call spread." This purchase is actually a series of purchases and sales. It starts with a purchase of a call option on the stock market index that is in-the-money. An in-the-money call option will provide a gain should the change in the index be positive one year later.
3. If the insurance only bought this one in-the-money call option, the sky would be the limit to the upside potential. However, this type of call option is generally expensive. In this example, we will assume this call option costs $600, which is $100 more than the amount the insurance company has to work with.
4. To make up this difference, the company sells a call option to somebody else. That person or entity would participate in gains beyond a certain point. That is how the index crediting cap is determined.

Hypothetical example of a policy at issue



5. If the stock index is higher at the end of the index period — great! Profits from the call options are applied as index credits to the index account. If the index is lower, the insurance company lets them expire and the zero percent floor preserves the index account's value.

Why do index cap rates change?

The interest rate environment

The interest rate environment has an effect on the insurance company's general account portfolio, but only over long periods of time. A long-term low interest environment will slowly lower the general account over time as the insurance company continues to invest. The opposite is true as rates rise. The general account's yield will slowly rise as the insurance company continues to invest. Since the general account's yield is responsible for the zero percent floor, as the yield gets lower, the amount of the premium needed to support the floor will go up, leaving less premium to invest in the bull call spread. As the yield goes up, more premium is available to purchase a bull call spread.

Market volatility

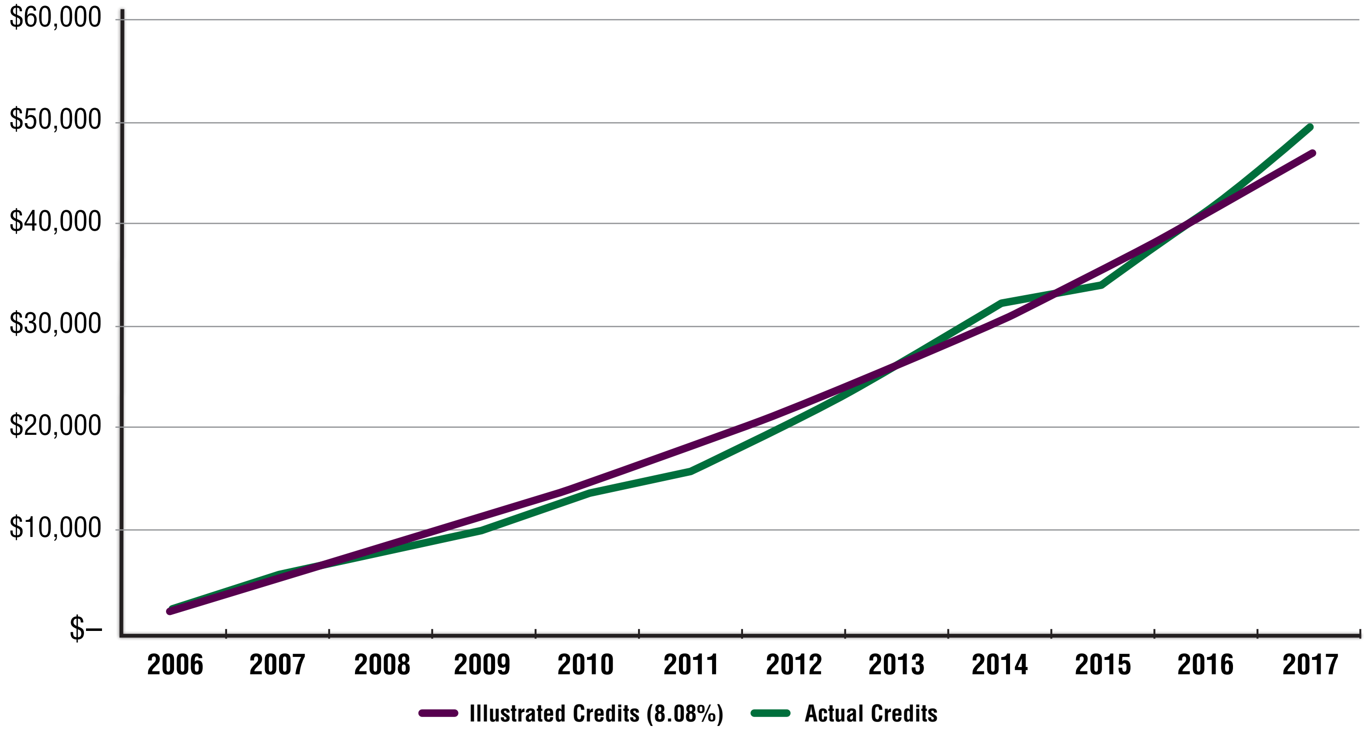
One of the major components that determines the price of options is the volatility in the stock market. The "VIX Index" measures stock market volatility. As market volatility rises, the price of options rises. As options get more expensive to buy, pressure to lower the index account's cap rate rises. The opposite is also true, as volatility lessens, option prices become lower and it becomes possible to support a higher cap rate.

Company strength and performance matters

North American has a history of strength and stability, weathering the storm through low interest environments and times of stock market volatility. In fact, North American's product portfolios have performed as illustrated since their inception.

This graph compares actual index credits of a first-generation Builder IUL to an illustrated rate of 8.08%, which was the default illustrated rate at that time. Throughout the ups and downs of the market, and even in the current low interest rate environment, North American's Builder IUL has performed as illustrated back when it was first sold in 2005.

Account value performance



Source: Internal calculations, July 2018
Builder IUL (Gen 1) Issued October 1, 2005, Male Preferred Plus Issue Age 45
Death Benefit = $150,000, Annual Premium = $3,000 allocated to S&P 500 Annual Pt-to-Pt

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Indexed Universal Life products are not an investment in the "market" or in the applicable index and are subject to all policy fees and charges normally associated with most universal life insurance.

THE S&P 500® COMPOSITE STOCK PRICE INDEX

THE S&P 400® COMPOSITE STOCK PRICE INDEX

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