**IUL Illustration exposure as follow-up to 12/8/21 LATF session**

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**By COB February 4**

Request for comments:

In general, the indexed universal life illustrations post-AG 49-A have shown lower credited rates and related values than we saw prior to AG 49-A. However, those illustrated rates and values may not be lowered by as much as contemplated when the Guideline was adopted.

A key issue identified is an increased use of volatility-controlled funds. These funds rebalance between equities and fixed income as equity volatility fluctuates.

In certain subsets of history, the uncapped volatility-controlled funds performed better than capped S&P 500 funds. Our research found that some insurers are or are potentially planning on using this result to only use a portion of the hedge budget (the amount of assets left over after funding the zero-return floor) on providing the upside potential and using the remainder to fund a fixed bonus to the policyholders.

In some insurers’ minds, this allows them to illustrate volatility-controlled funds plus the fixed bonus more favorably than a traditional, capped S&P 500 index.

That is the main issue regulators have identified at this point. We would welcome comments, by February 4, 2022, on whether and how to address that issue in early 2022.

Background on IUL illustration issue:

NAIC model regulation 582 contains standards for life insurance illustrations. A key component of Model 582 is the illustrated scale, which constrains how non-guaranteed elements such as credited interest rates are presented to life insurance customers. Limits to what can be illustrated include that they should be no more favorable than current credited rates and past credited rates.

In 2015, because of range of practice regarding handling of exotic indices and how to look back at past credited rates, and because loan arbitrage, AG 49 was developed. The thought was that IUL had unique aspects that were not appropriately clarified in the model reg, and therefore an AG was needed.

AG 49 eliminated the favorability of illustrating exotic indices, defined the lookback method, constrained loan arbitrage, and required an alternate, more conservative scale to be illustrated side by side with the illustrated scale.

In 2020, IUL products which applied fees to purchase multipliers were identified as an issue – these led to higher illustrated performance than contemplated when AG 49 was developed.

This led to adoption of AG 49-A. It appears that IUL products no longer contain multipliers that illustrate more favorably than products without multipliers.

Background on volatility-controlled funds:

Volatility-controlled funds have been around for at least 10 years. With variable annuities, compared to pure equity funds, they can provide downside protection to the company and the policyholder.

The way they work is a volatility-controlled fund may be heavy in equities during low equity volatility environments and then when volatility goes up (usually following a stock market downturn), the fund will shift away from equities and towards fixed income securities. The thought process is that further market downturns are more likely during volatile times than during stable times. The market movement can go either way at any time; therefore, long-term comparisons between volatility-controlled funds and 100% equity funds may be mixed.

In IUL, with S&P equity funds, to be able to ensure a non-negative return floor when the stock market goes down but provide upside when the stock market goes up, the upside potential is typically capped. So, instead of your AV going down 30% when the market goes down 30% and up 30% when the market goes up 30%, the range of AV movement may be between 0% and 10%.

In IUL, with volatility-controlled funds, the downside protection is still there. However, these funds may be marketed as uncapped but not provide close to the upside potential as an uncapped S&P 500 fund.

Prices in the stock and derivatives market drive how high the cap is for capped S&P 500 funds and may drive the portion of a volatility-controlled fund that’s in equities. Part of the person’s account value, called a hedge budget, is invested in these derivatives to provide the upside potential.

There is one or more company that has had this fund strategy in place in the past and several others that have started to incorporate this fund strategy after AG 49-A was adopted.