Unit Linked Life Insurance

The Beginning

- Started in the UK about 1960.
- Initially started by unit trust (mutual fund) companies to take advantage of the tax credit offered for Life insurance.
- Regular premium policies
- Typically 90% of the premium bought units in the unit trust on behalf of the investor.
- Life insurance at a minimal level to qualify the contract for the tax credit.
- 10% of the premium used for expenses, life cover and profit

Property Bonds

- Property prices were rising rapidly at the time.
- Unit trusts were not permitted to invest in property
- Insurance companies were.
- The property was held by the companies in internal unit funds run according to unit trust principles.
- Mainly single premium policies with minimal life insurance included.
- Regulatory arbitrage

Broader penetration

- When property prices began to fall the companies offered links to equities and other investments.
- Unit trusts had limited charges and paid little if any commission
- They were bought only by informed or wealthy investors
- Greater flexibility on charges allowed unit linked policies to pay commission to salespeople

Largely Unregulated

- During this period there were no regulations specific to unit linked business
- It was largely unregulated except for the capital requirement insurance companies and for actuarially certified reserves.

Increasing Share prices

- Unit Linked insurance developed rapidly when share values were increasing fast
- Customers of traditional with profit policies felt they were losing out as insurance companies were reluctant to include the capital gains in the bonus calculations.
- In creasing computer power allowed greater flexibility

Regulation

- Fit and Proper persons
- Annual Actuarial valuations
- List of assets that could be held in unit funds
- Conflicts of interest between company and policyholders
- Reserves for maturity guarantees

Regulation 2

- Cooling off period
- Growth rates to be used for illustrations
- Information to be provided to the policyholder before purchasing
- Matching of units allocated to clients policies with those held by the company

Unit linked policies

- Majority of New Business now unit linked
- Products offer extreme flexibility and transparency

Unit linked policies 2

- Operate as an individual account for each policyholder
- Premiums paid are credited to the account
- Specified charges are deducted for
  - Expenses
  - Life insurance
  - Any other insurances (premium waiver on sickness, disability insurance etc)
- The balance of the premium is than invested in buying the selected units

Traditional Policy

Premiums

Death

Sum Insured

Maturity

Sum Insured

Unit Linked Policy

Premiums

charges

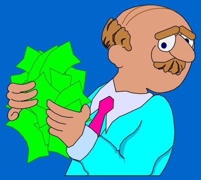
Insurance fund

Death

Balance of sum insured

Units

Maturity Unit Value



Flexibility

- Premium can be increased at any time. Extra premium buys more units
- Provided sufficient remains to cover charges premium can be reduced and less paid
- If premium is not enough for the charges units can be sold to cover any shortfall
- Iinsurance benefits can be increased, decreased, added or removed
- Units can be cashed of the client need funds without discontinuing the policy

Insurance Cover

- Insurance cover additional to or inclusive of unit value
- Thus if cover $100,000 and the value of units $25,000
  - Inclusive cover pays on death $100,000 ($75,000 as an insurance benefit and $25,000 from the units)
  - When calculating the charge for inclusive cover only the insured amount of (in this case $75,000) is charged for
- Additional cover pays $125,000
- Insurance charges are based on YRT rates (although generally charged monthly)

Investment flexibility

- Companies generally offer a range of funds
    - bond or fixed interest fund
    - deposit fund
    - local equity fund
    - worldwide equity fund
    - property funds
    - managed fund offering a mix of investments selected by the company
- Units can be in internal funds or external units trusts

Investment flexibility 2

- Client can select fund or funds for his investment. Reflecting his risk appetite and views.
- Money for unit purchase is then invested in those units in the proportions specified by the client.
- Fund choice can be changed for future premiums.
- Existing units can be sold and other bought to change the investment of existing funds.

Guarantees

- Plans can offer a guaranteed minimum value at maturity
  Now rarely offered

Transparency

- Regular statements can be provided to the client so they can see what their money has been used for and the value of units credited to the plan.

Hiding charges

- The YRT rates used inflated to include a margin
- Company may get a discount on external units bought which are not passed on to the client
- There can be a number of different charges levied all apparently small but significant in total

Types of Charges

- % of premium charge
- An initial charge as % of first years premium
- Unit charges hidden in the unit prices
  - An initial charge as a % of units bought eg 5%
  - An annual or monthly charge based on the value of the units say 1% pa
- Initial units with a heavier annual charge bought with the first 2 years premium
- A monthly administration charge
- Fees for changes to the policy
- A back end charge deducted at maturity

Simple Example

Yearly Premiums	20,000 Rb	
Sum Insured	200,000 Rb	
Fees		
Initial fee 40%	premium	
1.50%	pa on fund	
1,000 Rb annual charge		
Assume Unit growth	6%	p.a.
Mortality charge	0.50%	of sum at risk

Simple Example

Year	Premium Paid	Fee	sum at risk	Mortality Charge	Unit value purchased	Unit Value after premium payment	Unit value at year end	Fund fee	Net unit value
1	20,000	9,000	189,000	945	10,055	10,055	10,658	160	10,498
2	20,000	1,000	170,502	853	18,147	28,646	30,365	455	29,909
3	20,000	1,000	151,091	755	18,245	48,154	51,043	766	50,277
4	20,000	1,000	130,723	654	18,346	68,624	72,741	1,091	71,650
5	20,000	1,000	109,350	547	18,453	90,103	95,509	1,433	94,077
6	20,000	1,000	86,923	435	18,565	112,642	119,401	1,791	117,610
7	20,000	1,000	63,390	317	18,683	136,293	144,470	2,167	142,303
8	20,000	1,000	38,697	193	18,807	161,110	170,776	2,562	168,215
9	20,000	1,000	12,785	64	18,936	187,151	198,380	2,976	195,404
10	20,000	1,000	-	-	19,000	214,404	227,268	3,409	223,859

Inflation

- For a long term contract the company needs to carefully consider the impact of inflation.
- Variable charges.
- Limits for consumer protection
- A typical limit might be a specific measure of inflation.
- Administration costs (largely staff costs) tend to increase faster than retail prices

Internal Funds

Where internal funds are set up these are treated as if they are separate entities from the other parts of the company (the general fund). From an accounting point of view it is as if each unit linked fund and the remaining general fund of the company are subsidiaries with the overall company a holding company.

Balance Sheet

	Equity Fund	Bond fund	Deposit fund	General fund	Total company
Actives	xxxx	xxxx	xxxx	xxx	xxx
	xxxx	xxxx	xxxx	xxx	xxx
	xxxx	xxxx	xxxx	xxx	xxx
Passives	xxxx	xxxx	xxxx	xxx	xxx
	xxxx	xxxx	xxxx	xxx	xxx
	xxxx	xxxx	xxxx	xxx	xxx

Internal funds (cont)

- Premiums for unit linked policies are credited to the general fund.
- The part of them used to purchase units is then transferred to the appropriate unit linked fund.
- Fund charges are transferred from the unit linked funds to the general funds.
- If a client dies the value of the units is paid from the unit linked fund and the balance of the sum insured from the general fund.

Internal funds (cont)

- On maturity the unit value is paid from the unit linked fund.
- Any dividends and interest received on the investments are paid to the unit linked fund.
- Purchases of investments are made from the unit linked funds and any sale proceeds credited to them