Executive Benefit Solutions

IUL Cap Rates: How They Work, Why They Change, and What It Means for You

A Plain-Language Guide from Executive Benefit Solutions

How Does an IUL Policy Earn Interest?

An Indexed Universal Life (IUL) policy offers a distinctive way to accumulate cash value. Rather than earning a fixed rate of return, your cash value participates in the performance of a market index — most commonly the S&P 500 — subject to two important guardrails:

FLOOR	CAP
Typically 0%	**Set by the carrier (e.g., 9.00%)**
Your account value cannot decrease due to market losses. If the S&P 500 drops 30%, you are credited zero — not a negative number.	The maximum interest rate credited in any one policy year, regardless of how high the index actually performs.

Importantly, the carrier does not invest your premium directly in the stock market. Instead, they use a portion of the interest earned on your premium to purchase index options — financial instruments that replicate market upside within the floor-to-cap range.

Where Does the Options Budget Come From?

When you pay a premium, the carrier invests those funds in their general account — a portfolio of high-quality bonds and fixed income securities that generates a steady annual yield. From that yield, the carrier sets aside a portion — commonly referred to as the Options Budget or Hedge Budget — to purchase index options each year. The remaining yield covers operating expenses, profit margin, and the cost of supporting the guaranteed 0% floor.

In practice, the precise allocation of yield across these components varies by carrier, is managed at the portfolio level across all in-force policies, and is not disclosed in the form of a simple per-policy breakdown. The table below is a conceptual illustration only — it is intended to convey the general economic logic, not to represent the actual internal accounting of any specific carrier.

Simplified Conceptual Illustration — Not Actual Carrier Accounting

Component	Hypothetical Example
General account portfolio yield	5.00%
Less: carrier expenses & profit margin	(2.50%)
Less: cost of supporting the 0% floor guarantee	(1.25%)
Remaining yield available for index options (Options Budget)	**1.25%**

Note: Actual carrier economics are significantly more complex. Portfolio yield, option pricing, expense loads, and profit targets are managed across the entire in-force block and vary by product, carrier, and market conditions. The figures above are hypothetical and used solely to illustrate the general relationship between portfolio yield and the options budget.

The carrier uses the options budget to purchase 1-year call spreads on the S&P 500 — buying participation above 0% and selling it off at the cap level. The cap is set at whatever level the options budget can support at current market prices. This is why the cap is a market-driven outcome, not an arbitrary decision by the carrier.

Why Do Cap Rates Change?

Cap rates are not permanent — carriers can adjust them when market conditions shift. Two primary forces drive cap rate reductions:

Reason 1: Portfolio Yield Declines

If the carrier's general account earns less — for example, higher-yielding bonds mature and are reinvested at lower prevailing rates — the options budget shrinks. A smaller budget can only purchase a lower cap, even if option costs are unchanged.

Reason 2: Options Become More Expensive

Index options are priced based on market volatility (reflected in the VIX). When volatility rises, call options cost more. The same budget that supported a 9.00% cap in a calm market may only support an 8.50% cap when markets are more volatile.

⚠ Important Protection: Once Your Segment Starts, the Cap is Locked In

Once a 1-year index segment begins, the cap rate for that segment is fixed for the entire policy year and cannot be changed mid-segment. If your segment starts on January 1st with a 9.00% cap, that 9.00% applies through December 31st — regardless of any cap rate changes the carrier makes afterward. Cap adjustments only affect new segments that begin after the change takes effect. Policyholders in an active segment are fully insulated from any near-term cap reductions.

How Cap Rates Connect to Your Policy Illustration (AG49)

Actuarial Guideline 49-A (AG49) is the regulatory framework governing how interest rates may be illustrated in IUL policy projections. Its purpose is to ensure that the returns shown in proposals are realistic and grounded in historical data.

Under AG49, the maximum illustrated rate is calculated by applying the current cap rate to 25+ years of actual S&P 500 historical annual returns and computing the average credited rate that would have resulted. The key mechanic is straightforward: in any year where the S&P 500 return exceeded the cap, the policyholder would have been credited only the cap rate — not the full market return. Because the S&P 500 periodically produces returns well above the cap (strong bull market years), a lower cap directly reduces the interest credited in those years. With a 9.00% cap, a year in which the index returned 20% still credits 9.00%. With an 8.50% cap, that same year credits only 8.50%. Multiplied across several years when actual returns exceed the cap in the historical lookback, a 0.50% cap reduction lowers the average credited rate — and therefore the maximum rate that AG49 permits a carrier to illustrate.

Understanding IUL Cap Rates & AG49

Illustration Component	9.00% Cap	8.50% Cap
Current cap rate	9.00%	8.50%
AG49 max illustrated rate (example)	~6.50%	~6.33%
20-year illustrated cash accumulation	Base case	Modestly lower

✓ Key Takeaway

A cap rate reduction — such as from 9.00% to 8.50% — ripples through policy illustrations because AG49 requires the maximum illustrated rate to be recalculated using the new cap. In any historical year where the S&P 500 returned more than the cap, the lower cap means less credited interest. Those reductions accumulate across the entire 25+ year lookback period, pulling the average — and the maximum illustrated rate — lower. Illustrated accumulation values in new proposals will reflect this. However, existing segments already in force are completely unaffected — those policyholders continue earning under the cap that was locked in when their segment began.

Putting It All Together

Here is the straightforward story behind IUL cap rates:

- The carrier earns interest on your premium through a general account portfolio composed primarily of bonds.
- A portion of that interest — the options budget — is used each year to purchase index options that create your upside potential.
- The cap rate is simply the highest return a carrier concludes the options budget can afford to support. It is driven by market forces, not arbitrary carrier decisions.
- When portfolio yields fall, or when market volatility makes options more expensive, the options budget buys less upside — and a carrier is likely to reduce the cap.
- Once your 1-year index segment begins, the cap is locked in for that full year. Cap changes only affect new segments going forward.
- Because the S&P 500 delivers returns above the cap, a cap reduction lowers the interest credited in those historical years — which under AG49 reduces the maximum illustrated rate and the accumulation values shown in new proposals.
- It's important to note that the AG49 rate is maximum rate a policy can be illustrated at, not the maximum interest rate your policy might receive, The maximum interest rate your policy might receive is the cap rate in effect at the start of any 1-year period.

Questions? Contact your Executive Benefit Solutions consultant.