

2001 CSO Q&A

By Andrew Erman

With the ink still drying on the new 2001 CSO tables, we have already seen a wealth of articles on this subject from a spectrum of highly skilled actuaries. With this volume of discussion, there are likely to be some misunderstandings. This article attempts to clarify some of the more difficult points that you may be contemplating as you look at your product development needs.

Does the tax code (section 7702) specify the CSO tables to use in calculating guideline premiums? It gets there but not directly. Section 7702 requires insurers to base their calculations on “reasonable mortality charges.” The code provides more guidance and specificity on the *maximum* that those reasonable mortality charges can be, but it does not promulgate any specific table for *reasonable* mortality charges. The next question will help explain.

Why is 1980 CSO the mortality basis for calculating section 7702 guideline premiums? As mentioned above, section 7702 requires companies to use “reasonable mortality charges” in calculating guideline premiums, and Treasury was directed to issue regulations making this more specific. As of the writing of this article, they are almost 13 years behind their due date! The IRS issued a notice, under circumstances that are different from today, explicitly identifying 1980 CSO as a safe harbor. However, this will not become 2001 CSO unless Treasury or the IRS intervenes. Again, the next question will help explain even more.

OK, but I know I’ve heard of a link between section 7702 and section 807 (tax reserves). What is that all about? In section 7702, it does refer to section 807 for the *maximum* mortality charge that can be used for section 7702 calculations. This is different from the *reasonable* charges mentioned above, although those reasonable charges generally do need to be within the maximum. If we don’t have specific guidance on the transition, some experts refer to this linkage and to section 807 for guidance.

Wait a minute. Are you saying that we don’t have to use 2001 CSO in our section 7702 calculations? Not exactly. I think all the experts agree that at some point in the future, insurance companies will need to use 2001 CSO to calculate guideline premiums. The debate, which is mostly academic, is over “when” and “where.” The debate over “when” refers to whether the three-year transition will apply. The debate over “where” refers to where in the “rules” this will be required; i.e., reasonable mortality charges, maximums, or other. Getting into details beyond what has already been discussed is a bit beyond the scope of this article, but the next two questions may provide you with some relief, if you’re struggling with all of this.

How does the three-year transition rule fit with this? As noted above, section 7702 refers to section 807 (specifically, section 807(d)(5)) for what tables are the maximum mortality charges to use. Section 807(d)(5) has five sections, but section 7702 does not refer to any specific section within section 807(d)(5) — it refers to the whole thing. One could argue that all apply. The first section, section 807(d)(5)(A), defines prevailing tables and the second section, section 807(d)(5)(B), provides for the three-year transition. Under the argument that all sections apply, then the three-year transition rule would also apply, giving insurers relief in transitioning to the new tables, in absence of specific guidance from the IRS or Treasury.

Will we get better guidance on this? It is likely that the IRS or Treasury will provide more specific guidance on this, which is the primary reason I feel the above debate, over “when” and “where,” is academic. In the scenario where we do not get any guidance, the best folks to ask are your company attorneys, since this is a legal question. Technically, in absence of guidance, the current safe harbor of 1980 CSO would stay as the safe harbor, but it will be a moot point when the lower rates become the new maximum. Further, the three-year transition rule would seem to apply to the extent that section 7702 relies on all of section 807(d)(5) rather than just section 807(d)(5)(A). Again, your attorneys are the ones to ask, and their opinions are likely to vary across companies based on the facts and circumstances of each company.

What is “hardcoded” into section 7702? The endowment age of 95 to 100 is in section 7702, and it would require the involvement of Congress to change. Similarly, the corridor factors are also hardcoded into section 7702 – they, too, would require Congress to change. Additionally, the 4 percent and 6 percent interest rate assumptions are also hardcoded into section 7702. If any one of these items is opened for questioning, it is very hard to imagine the others not being brought to the negotiating table, as they are all out of sync with recent developments. Note that the CSO tables as a safe harbor for mortality charges are *not* hardcoded into section 7702, as already mentioned above.

With the tables’ new endowment age, will guideline level premiums significantly increase? This seems to be getting a lot of discussion, but the answer to the question, as written, is no. The higher endowment age, alone, will not increase guideline level premiums. When some folks talk about higher guideline level premiums, there are assumptions involved, one of which is unlikely. The assumption that I question the most is whether the IRS will really allow the higher endowment age. Keep in mind that the section 7702 endowment age is hardcoded, and it would require the involvement of Congress to change. The fact that we, as actuaries, increased the endowment age does not imply that the lawyers and legislators will follow suit. Many do not think they will. Also keep in mind that if we open up the endowment age, then we also open the door for discussions on the corridor factors, as well as what could turn into an unfavorable discussion on clarifying “reasonable mortality charges.” These are all hardcoded. Is it possible? Of course, but as actuaries, I believe we have a responsibility to our insurance company management and to our clients to make sure that they are properly advised on the thin feasibility of this outcome. Additionally, in terms of the level of the increase, you

may wish to run the numbers yourself, as there seems to be some variability on how much it can increase.

Does codification help uniformity? That depends on your state of domicile. If your state of domicile explicitly references 1980 CSO, then codification probably would not supersede it. If your state of domicile is silent, codification might provide some relief.

Is the maturity age 120 or 121? Between issue age and maturity, the 2001 CSO tables have 21 more “entries” than the 1980 CSO tables. If you are accustomed to thinking of the 1980 CSO table ending at age 99 (i.e., at the end of age 99), then substitute age 120 when talking about 2001 CSO. If you tend to say that the 1980 CSO has an endowment age of 100 (e.g., the anniversary nearest attained age 100), then substitute age 121 when talking about 2001 CSO.

Will 2001 CSO be the new maximum for UL COI rates? The Academy’s CSO Implications Work Group could not find an NAIC rule that requires UL COI rates to be no greater than the CSO Tables, and it found such a rule to be inappropriate, if it were to be imposed. However, this does not imply that the work group did a thorough 50-state search. It is likely that some states will resist a filing with maximum COI rates higher than 2001 CSO, and the reality for most companies will be whether it is worth the trouble to forge the argument with those insurance departments. The squeeze will be the greatest for a company with extra underwriting categories, higher than average mortality, on a product chassis with relatively low interest rate or M&E spread.

Where can I get more information? Some will come over time. We need guidance from the IRS or Treasury; we have state variations that will bubble up, etc. You will also benefit by exploring two reports produced by the Academy of Actuaries, which can also be found online at http://www.actuary.org/life/cso_0702.htm and http://www.actuary.org/life/cso_0902.htm. The first report supports the development of the tables and its valuation effects. The second report looks at nonvaluation implications. Many consulting firms can also be a tremendous help in navigating these intricacies, particularly as they begin to specialize in the new tables.

Best of luck!

Andrew Erman chairs the American Academy of Actuaries CSO Implications Work Group.