

Regulatory Alert for Life Insurance Product Development Actuaries

LIFE INSURANCE PRODUCT DEVELOPMENT has always been sensitive to both statutory and tax reserve requirements. Recently, several proposed or approved regulatory changes have added new wrinkles that the product development actuary will need to consider. Among these are proposed actuarial guideline AXXX, newly approved actuarial guideline 37 covering variable life guaranteed minimum death benefits (GMDBs), and the proposed 2001 CSO valuation mortality table.

Actuarial Guideline AXXX

Since the adoption of Regulation XXX, there have been several term and universal life (UL) products developed with level premiums that appear guaranteed (to the policyholder) but don't require XXX-style reserves. Those products mostly fall into one of the following broad categories:

- Products having level premiums that aren't guaranteed, but for which any future premium increase triggers some sort of compensating bonus or refund.
- Products having level premiums that are guaranteed, unless some unlikely specified future event occurs (e.g., Moody's bond yield index falls below 3 percent).
- Products having guaranteed dividends or refunds that, when applied to nonlevel guaranteed premiums, net out to a guarantee of a level policyholder cash flow.
- Products having a nonguaranteed level premium pattern, but with a level premium guarantee issued through an affiliated nonlife company via rider, reinsurance, or some other arrangement.
- Products having a universal life structure, where the guaranteed charges for a no-lapse period are nonlevel, but for which (due to a prefunding or shadow fund provision) a guaranteed level pattern can be computed and illustrated.

Due to concerns about these methods of avoiding XXX-style reserves, the NAIC has proposed a new actuarial guideline known as AXXX. At the time of this writing, the guideline is out for reexposure but is likely to be adopted some time in 2002. The format of AXXX is to give examples (like those summarized above) of questionable products, and then to state how they should be reserved for. The examples are expressly stated not to be all-inclusive;

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just because a new design isn't on the list doesn't necessarily exclude it from the guideline.

The general method of dealing with products covered in the first three bullets above is quite

straightforward. The guideline simply states that because a company isn't able, completely at its own discretion, to raise premiums, these products must be reserved for as though there were a complete guarantee.

The fourth bullet refers to a fully guaranteed product where the guarantee involves a second company—possibly through a rider offered by an affiliated nonlife company, or perhaps through reinsurance. In this situation, AXXX requires that the total of the net reserve held by the direct writer and the reserve held

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by the second company must at least equal the gross reserve that would have to be held by a single company issuing the product in question.

For shadow fund products (the fifth bullet), the guideline requires that any prefunding of a shadow fund guarantee result in a higher reserve than there would be without the prefunding. As the product becomes more prefunded, the reserve approaches the statutory net single premium that would cover the remainder of the guarantee period. Without going into any more detail here, suffice it to say that the additional reserves required would largely negate the value of this design in lowering XXX-related basic reserve strain.

There's an important distinction drawn in the current version of the guideline. Normally, actuarial

guidelines, since their function is to interpret regulations already in place, are applied retroactively. In this case, however, the shadow fund guidance would only apply beginning in the calendar year after the guideline is approved.

Assuming AXXX is approved, product development actuaries will likely be busy later this year, once again redesigning protection-oriented term and universal life products. The shadow fund may well remain with us, because of its flexibility, but the other twists mentioned in AXXX are likely to become more scarce.

Actuarial Guideline 37

Reserves for VUL no-lapse guaranteed minimum death benefits (GMDBs)—which generally provide that a policy will not lapse regardless of fund performance, subject to payment of a specified minimum premium—were first addressed in the Variable Life Model Regulation promulgated in 1983. This regulation set forth different calculations for fixed premium and flexible premium products. Both sets of specified calculations are open to interpretation in certain aspects.

The 1983 regulation specified that for a fixed (or scheduled) premium contract, the GMDB reserve should be the greater of: 1) the one-year term cost for the excess of the GMDB over death benefits provided for in the account value, assuming a one-third drop in that account value; or 2) the attained-age level reserve (which builds up over time if the GMDB is underfunded on a statutory basis by the current account value plus future required premiums).

This original version of the regulation specified that a GMDB reserve for a flexible premium contract should be the total of all term costs for the excess of the GMDB over death benefits provided for in the account value, assuming a one-third drop in the account value. The term costs are for the period of the guarantee, and thus are not limited to a year.

A revised version of the variable life model regulation was promulgated later in the 1980s but adopted in just a few states. This revision consolidated the fixed

and flexible premium sections, and specified holding a reserve equal to the larger of:

- A one-year term reserve, based on a one-third drop in account value.

- An attained-age reserve, which follows a procedure similar to the original version, but which allows funding of this reserve over the “revenue collection” period for the GMDB, instead of the “premium paying” period.

Under the revised version of the regulation, the term reserve is limited to only one year, even if the product exists on a flexible chassis. This greatly reduces its impact, and makes future required premiums (which would be assumed to be paid annually) irrelevant. The attained age level portion can be minimized by having required premiums at least equal to the valuation premiums. (It can actually be eliminated at issue on that basis, but will only be zero in all future periods if separate account performance is good enough to keep fund values at least at tabular reserve levels.)

Because of a lack of uniform state adoption or consistency of application between the two VUL model regulations, actuarial guideline 37 has recently been developed and adopted. It clarifies both regulations, and adds some new calculation specifications.

The first important issue it tackles is the different methodologies for flexible and fixed premium contracts under the original regulation. The interpretation in the proposed guideline is that, if a contract specifies a required premium for continuance of a GMDB, that contract is *de facto* a fixed premium contract for purposes of the GMDB reserve, regardless of the overall nature of the VUL contract. Thus the treatment in the revised version of the regulation should apply to most GMDB contracts issued today.

It also makes some clarifications to the method of projecting contract values forward for the attained age level reserve:

- It specifies that the GMDB must be assumed to remain in force for its maximum duration. But one should also assume that for that reason, all minimum premium re-

quirements are met. (They are assumed to be met at the latest allowable point in time.)

- It makes no mention of projecting forward using expense loads. In doing the statutory projection of the fund value plus future required premiums, it would therefore seem allowable not to use them.

- It specifies costs of insurance rates for the projection as minimum valuation mortality. Thus, these projected rates aren't related directly to guaranteed COI rates, as some had previously assumed. This allows for use of the 10-year select factors from 1980 CSO, regardless of what is used for basic policy reserves. Soon, it should allow use of select and ultimate 2001 CSO (when it becomes applicable).

- It defines GMDB revenue as either policy charges or premium. This allows a company to ensure that GMDB revenue is collected in all future years of a given no-lapse period, by defining a required policy charge for the GMDB that is unrelated to premiums collected. (An example would be a basis-point charge applied to the fund value.) According to the mechanics of the attained-age level-reserve calculation, this allows the company to ensure that any reserve increase is calculated using an annuity factor, rather than being assessed as a lump sum.

In general under guideline 37, minimization of GMDB reserves is best achieved by having required premiums that are nondeficient, and (especially for longer-term guarantees) assessing some charge unrelated to premiums collected, in order to maintain the benefit. But changes (from prior interpretations) in treatment of mortality charges, expense loads, and premium payment assumptions may cause different projections for reserve purposes from those done in prior years. Many actuaries may find that design changes are in order on their VUL secondary guarantees.

The Proposed 2001 CSO Table

Discussions at recent NAIC meetings have made it appear probable that the proposed 2001 CSO table will be adopted this year. If not, it should be adopted early next year.

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Adoption this year would probably result in many states adopting the table officially sometime in 2003. If 26 states were to adopt in 2003, that would have tax reserve (transitioning in over the subsequent three years) implications, with Section 7702-related changes likely to be required in the same time frame.

Interwoven throughout the discussions of fixed-product reserving as it is today under XXX and AXXX, and variable-product reserving under guideline 37, is an assumption that the 1980 CSO table forms the basis for the mortality underlying reserves. Regulation XXX provided some relief for fixed products by allowing longer and lower select factors to be applied to the ultimate rates, and X-factors to be used for deficiency reserve calculations. For variable products, only the

10-year select factors adopted with the basic 1980 CSO table seem to apply.

When the 2001 CSO table is adopted, this would appear to level the playing field quite a bit. At that point, the same basic reserve mortality will apply to both fixed and variable products. (The fact that fixed products can still use X-factors for deficiency reserves will offset the fact that deficiency reserves don't apply for variable products.)

Clearly, the advent of 2001 CSO will lower required reserves for many other products as well—particularly traditional ones. Term insurance may become somewhat less expensive, and participating whole life premiums may become more competitive. Additionally, depending on state interpretations and requirements for guaranteed cost-of-insurance

(COI) rates, current COI charges on UL and VUL may have to be reduced on some products.

Some other product design issues related to adoption of the 2001 CSO table center around 7702 issues. Many accumulation-oriented products sold now work by minimizing the face amount sold for a given premium payment pattern. Once 2001 CSO becomes the prevailing table for 7702, the minimum face amount for any given premium pattern will be higher.

The bottom line is that when 2001 CSO becomes applicable for statutory and tax reserves (and these two will occur at different points in time for some companies, or even products within companies), product development actuaries should expect to be quite busy. ●

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