



*Since the National Association of Insurance Commissioners (NAIC) adopted the revised **Valuation of Life Insurance Policies Model Regulation (XXX)** in March 1999, many questions have been raised about whether and how XXX applies to certain policies.*

In the eyes of some observers, not all the disputes over the applicability of Regulation XXX are honest differences of opinion. Rather, those observers believe that some conflicts have resulted from attempts to skirt the spirit, if not the letter, of the law, frustrating both regulatory and industry actuaries who helped to revise the original XXX.

The fundamental law for life insurance reserving is the Standard Valuation Law (SVL). In essence, the SVL requires that reserves equal “the excess, if any, of the present value, at the date of valuation, of the future guaranteed benefits ... over the then present value of any future modified net premiums.”

“Modified net premiums” are equal to a uniform percentage of the guaranteed premiums required under the terms of the policy, with that “uniform percentage” being derived under the rules specified in the SVL.

Under this methodology, policies with high guaranteed premiums at later policy durations will have lower reserves than similar policies with a flatter pattern of guaranteed premiums, because the present value of the (modified) high premiums will be greater than the present value of the (modified) “flat” premiums.

Some actuaries were taking advantage of this perceived loophole by incorporating extremely high levels of guaranteed pre-

miums at the later stages of the policy. They used this technique simply to reduce reserves; there was no serious expectation that policyholders would actually pay those high premiums.

XXX attempts to eliminate this loophole by requiring that reserves be calculated for each level-premium segment individually, in addition to computing reserves over the entire policy duration.

#### **Brief History**

The NAIC adopted the original version of XXX in March 1995. Even though it was the product of a collaborative effort between regulators and industry trade groups over a period of almost seven years, it never achieved widespread adoption among the states.

In late 1997, industry representatives began trying to make changes to the model. During 1998, an ad hoc industry committee worked with the NAIC’s Life and Health Actuarial Task Force (LHATF) to produce a revised XXX. A huge amount of time and effort went into the process, including input from industry representatives, regulators, and committees of the Society of Actuaries and the American Academy of Actuaries. This work was completed in December 1998, and the model was adopted by the full NAIC in March 1999. As of this writing,

roughly three-fourths of the NAIC's members have adopted some form of XXX.

In the spring of 1999, regulators assumed that the primary remaining challenge in implementing XXX would be the official adoption by state legislatures by January 1, 2000. Unfortunately, that turned out to be an erroneous assumption. While the states proceeded to adopt XXX at a relatively smooth pace, some actuaries began to assert that XXX wasn't applicable to certain product designs.

Specifically, they contended that, given its literal wording, XXX did not apply to universal life policies containing "shadow accounts." (A "shadow account" is an account within a universal life policy whose only function is to determine whether the policy remains in force.)

This was a topic of discussion at the October 1999 meeting of the LHATF. The following excerpt is from the minutes of that meeting:

*A discussion occurred relative to a draft bulletin on the applicability of the Valuation of Life Insurance Policies Model Regulation (XXX) to policies containing "shadow accounts." A strong consensus emerged that policies containing "shadow accounts," as well as any other technique for creating long-term premium and benefit guarantees, are clearly subject to the requirements of XXX. Mr. Gorski stated "the question of whether they are within the scope is a 'no-brainer.' In fact, they are covered." He stated that "only a very, very, very, very narrow reading of that (i.e., XXX) would come to a different conclusion." Mr. Foley added that he was "incredulous" when he heard of this approach, and he believes that policies with 'shadow accounts' are undoubtedly subject to XXX. Mr. Boerner stated that, while there may be some differences of opinion as to how to calculate the reserves for "shadow accounts," there is no question that such policies are within the scope of XXX. Representing the ACLI, Mr. Schreiner stated that "I would just like the record to show that the ACLI is working very hard to see that this is adopted in the states. We seek a level playing field, and we support the conclusions of the Task Force."*

The minutes also contain this comment: "In summary, Mr. Foley stated that, while there is nothing inherently wrong in 'shadow accounts,' it is patently illogical to argue they are not subject to XXX."

As the above excerpts make clear, a majority of the LHATF members were somewhat frustrated that this question had even come up. Their hope was that this strong statement would be enough to halt widespread efforts to search for loopholes, either real or imaginary, in the model. Once again, that proved too optimistic an assumption.

### Continuing Questions

As the spring of 2000 dawned, "creative" product designs began to sprout like the buds on the trees. Also growing at a rapid pace was the frustration level of a majority of the LHATF members. That summer, the NAIC initiated efforts to develop an actuarial guideline specifying the manner in which XXX applies to shadow accounts and other product features.

(Some of those "other" product features are enumerated in the "Fact Sheet" attached to this article as a sidebar. Essential-

ly, these designs fall into two camps: (1) the "guaranteed" policy features are triggered only by the occurrence of relatively unlikely events, thereby raising a question as to whether the reserves should be computed on the basis of these "guarantees," and (2) the policy designs are based on what many perceive to be narrow interpretations of the literal wording in XXX.)

During this period, an editorial appeared in the August 28, 2000, edition of the *National Underwriter* entitled "This Kind of 'Creativity' Needs Some Restraint." It became a major topic of discussion at the October 2000 LHATF meeting. During that discussion, members of the audience commented that there might be a role for the Actuarial Board for Counseling and Discipline (ABCD) in addressing these issues. The next month, Ken Porter, chair of the ABCD, participated on a conference call of the LHATF and explained what the ABCD can and cannot do in terms of publicly providing professional guidance versus private counseling and discipline.

With so many issues under consideration, it was difficult to reach a consensus regarding how to proceed in effectively enforcing XXX. A difference of opinion emerged on the LHATF regarding whether it would be appropriate to develop actuarial guidelines on XXX. An excerpt from the October 2, 2000, conference call of the LHATF summarizes this difference of opinion:

*Those against this idea stated that developing a guideline would be a tacit admission that the regulation is unclear, and they strongly believe the regulation is very clear. Those supporting development of a guideline stated that it would be useful in (1) emphasizing that XXX is applicable to the product designs that have recently appeared in the market, and (2) providing additional detail as to the mechanics of XXX's applicability.*

Even if regulators were to develop an actuarial guideline, it's unclear how broad a range of questions the guideline should attempt to address, as well as how liberally it could interpret XXX without exceeding its provisions.

### Lessons Learned

At its December 2000 meeting in Boston, the LHATF released a fact sheet to the states on this matter. Its purpose was "to make you aware of the product designs which have been brought to the attention of the NAIC's Life and Health Actuarial Task Force. Inclusion on this list is not meant to imply that a product is inappropriate or should be dealt with in a certain manner. It is simply intended to bring these designs to your attention."

The members of the LHATF believe that making sure the states are aware of the various product designs is a necessary first step in effective implementation of XXX. Also at the December meeting, the members reviewed the results of a survey

*XXX requires that reserves be calculated for each level-premium segment individually, in addition to computing reserves over the entire policy duration.*

# FACT SHEET—DECEMBER 2000

## *Valuation of Life Insurance Policies Model Regulation (XXX)*

The revised version of XXX was adopted by the NAIC in March 1999. Since that date, some actuaries have raised questions regarding whether and how XXX applies to various product designs. The purpose of this Fact Sheet is to make you aware of the product designs which have been brought to the attention of the NAIC's Life

and Health Actuarial Task Force. Inclusion on this list is not meant to imply that a product is inappropriate or should be dealt with in a certain manner. It is simply intended to bring these designs to your attention. At this point, it is not anticipated that updates of this Fact Sheet will be distributed. Should an actuarial

guideline or other interpretive document be produced in the future, that document will be developed and disseminated according to the relevant NAIC protocol.

### **Policy Designs That Have Emerged Subsequent to the 1999 Adoption of XXX**

a. An initial level premium rate is guaranteed for 10 years followed by increased guaranteed premiums for an additional 20 years. However, the company cannot increase premiums after year 10 (i.e., the initial premium continues to be charged) unless an unlikely event occurs (e.g., an index reaches an historically low level).

b. An initial level premium rate is guaranteed for 10 years followed by increased guaranteed premiums for an additional 20 years. However, after year 10 the policyholder is protected against premiums being increased above the initial level, with the protection provided by a second company through either reinsurance, a second policy issued to the consumer, or an agreement between the companies.

c. A product has relatively high gross premiums but with a guaranteed dividend

### **SAMPLE LETTER TO COMMISSIONERS**

Commissioner of Insurance  
Department of Insurance  
1234 Main Street  
Anystate USA 00000

Dear Commissioner:

I am writing to you in my capacity as chair of the NAIC Life and Health Actuarial Task Force. Attached is a Fact Sheet listing various product designs. Some actuaries have raised questions regarding whether and how the Valuation of Life Insurance Policies Model Regulation ("XXX") applies to these products. This Fact Sheet is provided solely for your information so that you will be aware of these designs. It does not represent an official position of the National Association of Insurance Commissioners.

Thank you for your attention to this matter.

Sincerely,

Tom Foley, Accident and Health Division Supervisor  
Kansas Department of Insurance  
Attachment

regarding regulator and industry attitudes toward how XXX affects various product designs, and whether an actuarial guideline is needed to clarify its applicability. While the survey didn't reveal a clear consensus on how to proceed, the LHATF did decide to continue work on developing an actuarial guideline.

After more than a decade of work and thousands of hours spent in research, discussions, and drafting, it would be nice to think we've learned some lessons from all of this activity. We think the two big lessons are:

- Cooperation among the regulators, professional actuarial bodies, and industry representatives is a necessary component to the successful development and adoption of a model. No one entity can successfully accomplish this goal. Each group brings a particular expertise to the process, and the good-faith efforts of each improves the final product. Plus, an added benefit of this cooperation is that it builds the political foundation for the model's adoption in the states.

- Cooperation among the regulators, professional actuarial bodies, and industry representatives is not a sufficient condition for

a successful implementation of a model. Once a regulation is finished and adopted in the states, the initial spirit of cooperation needs to expand to include all actuaries involved in the development and valuation of policies subject to the model.

No law can anticipate every future product design, and common sense and professional responsibility are needed to assure compliance with both the letter and the spirit of the law. If these attributes don't prevail, then everyone loses because: (a) regulators will be forced to develop regulations that are very restrictive in order to minimize the potential for "creativity," and (b) worst abuses will require sanctions by regulators and/or referral to the ABCD. This scenario is distressing in that it both discourages product innovation and creates an atmosphere of hostility that is fundamentally harmful to a healthy insurance market.

### **Conclusion**

While XXX is a complex regulation, its intent is clear: Companies need to establish reserves for the premium guarantees a pol-

or guaranteed refund schedule, or by some other means guarantees a low net cost to the policyholder.

d. A re-entry term product has an initial rate guarantee for 10 years, with loose or non-existent re-entry underwriting, allowing the policyholder to re-enter for an additional 20 years at specified favorable rates.

e. A term policy has an illustrated level premium for 30 years, the first 10 of which are guaranteed. Additionally, there is a refund option, which provides that a specified refund will be paid if the premium ever increases. The refund must be requested within a limited time (e.g., 30 days) of receiving notice of the increase. Coverage terminates if the option is exercised.

f. A reinsurance treaty provides for 30 years of level premiums on a current scale but directly guarantees those premiums for only the first 10 years. However, if the reinsurer increases the premiums after 10 years, the reinsurer agrees to increase the allowance such that the net payments (premium minus allowance) by the direct writer remain unchanged.

g. A universal life policy has provisions such that, if the UL policy lapses prior to the 10th policy anniversary because the actual accumulation value (or cash value, depending on design) falls below zero but stipulated premiums have been paid, a substitute policy is guaranteed to be issued providing the same amount of insurance coverage at the same stipulated premium for the remainder of the 10-year period plus an additional 20 years.

#### **Policy Designs That Pre-Date the 1999 Adoption of XXX**

a. A universal life policy allows the policyholder to pay premiums sufficient to maintain a non-negative balance in a memorandum (sometimes called a shadow or ghost) account, with

policy provides. Policy designs that are created simply to disguise those guarantees or exploit a perceived loophole should not be tolerated by either regulators or the actuarial community.

Not only does the creation of such policies disrupt the current product development and regulatory processes; it lessens the possibility that future valuation laws will incorporate increased reliance on the professional judgment of the actuary. If actuaries do, in fact, want a higher degree of freedom in setting reserves and other financial standards, they'll consistently have to display professionalism in applying the laws and regulations as they exist today.

We believe in the actuarial profession, and we're confident actuaries are ready to answer this challenge and work in a manner that meets both the letter and spirit of the law. ●

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the amount of premium not explicitly stated in the policy (e.g., the premiums required to keep the policy in force are determined by the interest credits and expense charges incorporated into the memorandum account calculations). The only purpose of the memorandum account is to determine whether or not the policy qualifies for the secondary guarantee (e.g., coverage remains in force as long as the memorandum account is not less than zero.)

b. A universal life policy has a cumulative "premium catch-up provision" in which the coverage is guaranteed to remain in force as long as a stipulated premium is paid each year, and where the insured is paying less than is required to maintain the guarantee but has the unlimited right to make up past premium deficiencies.

c. A universal life policy contains a provision whereby the policy will stay in force provided a specified amount of premium has been paid on a cumulative basis, but this specified amount of premium would otherwise be insufficient to keep the policy in force if the maximum policy charges and minimum interest credits were applied.

*This fact sheet represents the view of the Life and Health Actuarial Task Force and has not been adopted as the policy of the National Association of Insurance Commissioners. It is being provided as information to states in their review of insurance contracts.*

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