Rewriting Nonforfeiture Law to Rewrite Whole Life

THE YEAR 2010—when estate taxes are scheduled to be repealed for a year—will be critical for the life insurance industry. But it's also the year in which a long overdue new standard nonforfeiture law for life insurance policies may become effective.

The current standard nonforfeiture law, with some modifications, has remained essentially unchanged since 1948 (well over 60 years by 2010). There are portions of the current nonforfeiture statute that are out of touch with at least some of the current needs of the public and life insurance companies.

Given the long lead time needed to change any well-established insurance statute, it's not surprising that any new standard nonforfeiture law won't be finalized until another six to eight years from now, and that assumes that serious discussion about a new law begins in 2003.

This article will present the case for the need to update or even repeal the standard nonforfeiture law. It will explain some of the reasons this law isn't protecting insureds the way it's supposed to and, in fact, may be artificially inflating premiums for some forms of life insurance. While there are separate nonforfeiture rules for life insurance and annuities, this article will address only life insurance (although some of the comments will also be appropriate for annuities).

A Brief History

Nonforfeiture values (also known as cash surrender values) are the amounts in a cash value life insurance policy that a policyowner will receive upon surrendering the policy. Before 1948, some states had laws pertaining to nonforfeiture values, but they weren't uniform and they only applied to policies issued in that state. The current standard nonforfeiture law became operative starting Jan. 1, 1948, and was a significant improvement over the prior rules. The last major changes to the law occurred in 1980.

The standard nonforfeiture law specifies minimum cash values. The minimum values are based on an actuarial formula incorporated directly into the law. A company may guarantee cash values greater than the minimum level. The basis for minimum cash values depends on a maximum applicable interest rate and a required mortality table. The bases for the maximum applicable interest rate and the required mortality table are also incorporated within the law.

Over the past several years the life insurance industry has attempted to reexamine the mortality basis for required reserves. The culmination of this effort has been the 2001 CSO Mortality Table. Since this same table will be used for the calculation of minimum cash values, to an extent there has been a default effort to modernize the calculation of life insurance nonforfeiture values by using a more current mortality table. (If the current pace for introducing new CSO tables follows previous history, it'll be another 20 years or so before the next CSO table will be enacted.)

In calculating minimum cash values for currently issued policies, the nonforfeiture formula permits an expense allowance to recognize that companies have initial costs to recover and amortize before they pay a nonforfeiture value. Currently, this expense allowance is the sum of (a) and (b):

- **a** 1 percent of the average amount of life insurance over a policy's first 10 years (or $10 per $1,000)
- **b** 1.25 times the lesser of the statutory net level premium for the policy or 4 percent of the average amount of life insurance over the policy's first 10 years (or a maximum of 1.25 times $40 or $50)

For a level-face-amount policy the maximum expense allowance is $60 ($10 + $50) per $1,000.

Only by chance does the expense allowance approximate a policy's actual acquisition costs. Moreover, the formula doesn't recognize that expenses differ by type of policy, size of policy, etc. Small policies, for example, usually cost more per $1,000 of coverage to issue and maintain because basic company operating expenses are usually more or less fixed per policy, and such costs have to be

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spread over smaller amounts of coverage.

The 2003 Generally Recognized Expense Tables (GRET) show the following weighted acquisition costs:

2003 GRET Acquisition Costs

CATEGORY	AMOUNT
Per policy	$73.74
Per unit	$ 1.29
% of premium	60%

Using the 2003 GRET, the total expense allowance for a $10,000 whole life policy issued to a male age 60 with a premium of $400 is $327 or $33 per $1,000. In addition, there are acquisition costs for commissions, direct marketing expenses, and similar items. Thus, it makes it very likely that for most companies the expense allowances permitted by the standard nonforfeiture law are less than the expenses actually being incurred.

In one sense, the standard nonforfeiture law is like a pair of "one size fits all" socks. It neither allows nor recognizes that different distribution systems cost different amounts of money. Further, the standard nonforfeiture law also treats individual contracts with different underwriting and mortality alike. This approach may have been needed and appropriate when all nonforfeiture values were calculated manually, but with current technology it would be easy to customize nonforfeiture formulas to fit the characteristics and needs of different groups of insureds.

A little less than 10 years ago, the American Academy of Actuaries presented a report to the National Association of Insurance Commissioners titled a "New Approach to Nonforfeiture Law." The report proposed a more flexible system based on a nonforfeiture plan. Policy cash values could or could not be guaranteed under the proposed system. However, there has been no further action from this report.

Exceptions to the Standard Nonforfeiture Law

The standard nonforfeiture law permits several exceptions including reinsurance, group insurance, some forms of term insurance, and policies that develop cash values of less than 2.5 percent of the amount of life insurance at the beginning of a policy year. The exception for decreasing term insurance is only available for policies expiring before age 71. When a policy meets one of the exemptions, no cash values are required.

The exceptions to the standard nonforfeiture law were enacted to recognize situations where policies should not be required to provide nonforfeiture values. However, the excepting relating to group insurance would seem to create a tilted playing field in some instances. Why should insureds with identical benefits and guarantees potentially be treated differently with respect to nonforfeiture benefits simply because a policy is issued under an individual policy rather than a group policy?

Impact on Premiums

Nonforfeiture values generally have two recognized purposes: to protect the interests of a terminating insured as well as the interests of continuing policyholders. However, when any nonforfeiture values are paid, they're the same as any other expense; the premiums charged for the policy must be calculated to pay not only death benefits but also nonforfeiture values. In other words, there's a cost to a policyholder for a policy that provides nonforfeiture values.

As the standard nonforfeiture law now stands, a prospective policyholder can't elect to purchase some types of policies (e.g., whole life policies) without any nonforfeiture values, even though the cost of a policy without nonforfeiture values would be significantly lower per $1,000 of death benefit.

The cost of providing cash values varies by each type of policy, the insured's age and sex, etc. For example, the present value of providing minimum cash sur-

render values in a plain-vanilla whole life policy issued to a 60-year-old male is $4 per $1,000 amount of insurance. (The minimum cash surrender values are based on the 1980 CSO Mortality Table, Male, ALB with 5 percent interest. The present-value calculation is based on Linton C lapses and a 5 percent discount rate.)

Because life insurance policy structures (premiums, lapse rates, underwriting, etc.) vary by company, it's not possible to make a simple statement that providing cash values adds *x* percent to the premiums. Broadly speaking, however, the cost of providing cash values ranges from 10 percent to 30 percent. In other words, a policy without cash values would be considerably less expensive than a policy with cash values.

Since the cost is significant, shouldn't cash values be optional? Cash values are optional for other asset accumulation products, such as long-term care, so why shouldn't whole life insurance policies also offer the customer a choice?

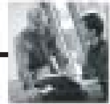
As mentioned previously, nonforfeiture values are required on the theory that policyholders who terminate before a policy's full term should be treated fairly. However, it must also be recognized that nonforfeiture values encourage policy lapses. As a result, anti-selection also causes an increase in mortality of long-term policies because terminating insureds are far more likely to be healthier than the continuing insureds. Actuaries might be able to use lower assumed mortality for non-cash-value whole life policies, which would further lower premium rates.

The New Nonforfeiture Market

When the standard nonforfeiture law was conceived and enacted more than 50 years ago, the life insurance market was totally different from today's. The universal life insurance policy wasn't even a dream in Jim Anderson's eye. (For younger actuaries, it was an article by Mr. Anderson back in 1975 that started the universal life policy boom.) And in the event that an insured no longer wanted to continue a policy, the only alternative was to stop paying premiums and exercise one of the available nonforfeiture options in order to recover any equity value from the policy.

The current situation, however, is very different. There's a growing and active market for "used life insurance policies." Life insurance policies are bought by life or viatical settlement companies. Granted, the secondary market for life insurance policies is now more likely to apply to larger face amounts, but it's a new and exciting activity that's bound to become more encompassing over time.

The life settlement market would seem to provide a far more equitable nonforfeiture value for an insured. It may even provide a greater benefit than the guaranteed nonforfeiture value stated in a pol-



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icy. For example, a policy covering a person in less than normal health at the time of termination is probably worth more as a life settlement than the nonforfeiture value provided by the policy.

Another significant advantage of the life settlement option is that any proceeds above a policy's cash value may be taxed at capital gains rates. Having capital gains rates apply to a monetary transaction is always an attractive feature.

The existence of the secondary market for life insurance policies creates an entirely new environment that needs to be factored into the role and provisions of any nonforfeiture law. The life settlement business is here to stay. In a perfect world the existence of an active life settlement marketplace should eliminate the need for a standard nonforfeiture law because it recognizes the "real" equity of an insured's value in a life insurance policy at the time of termination.

Nonforfeiture Laws in Other Countries

The requirements for minimum nonforfeiture values vary by country. In Canada there is no minimum standard nonforfeiture requirement. Canadian companies provide cash values based on competitive factors rather than determined by statute. The life insurance market in Canada has not imploded because of the lack of a nonforfeiture law, and companies offer nonforfeiture guarantees commensurate with the type of products being sold, without the stringent and sometimes artificial constraints of a standard nonforfeiture law.

Disclosure and Illustrations

Regardless of what nonforfeiture values a policy provides, the keys to the public's protection are effective and readily understood policy disclosure and illustrations. The protection sought by regulators, consumerists, and the life insurance industry is maximized when insureds read and understand the materials being provided. It's highly questionable if most new insureds read and grasp the significance of the documents they're now receiving and, therefore, whether they're being protected by current laws and regulations.

Any changes to the standard nonforfeiture law that create a flexible nonforfeiture structure need to be accompanied by improved disclosure and illustration. There already exists an "illustration actuary," so it would be a relatively simple addition to this person's responsibilities to oversee a company's nonforfeiture plan.

The 2010 Standard Nonforfeiture Law

As has been pointed out, the current standard nonforfeiture law is deficient in several areas. It limits consumer product choices and inhibits the development of new products. A number of options and opportunities exist for the structure of the 2010 standard nonforfeiture law, including but not limited to:

OPTION #1: Repeal the standard nonforfeiture law—let the marketplace determine to what extent and at what cost insureds want cash and other nonforfeiture values—and also develop more meaningful and understandable disclosure and illustration requirements. This is not an extreme measure given the existence of the life settlements market and the potential for expanding the role of the illustration actuary.

OPTION #2: If repeal isn't an acceptable option, then allow companies to create a nonforfeiture plan for each policy and tailor-make nonforfeiture values to that policy. Companies would have the option to guarantee nonforfeiture values.

OPTION #3: Update the specific exemptions in the standard nonforfeiture law. For example, allow policies of less than $25,000 to be exempt from nonforfeiture values in order to make a basic level of life insurance more affordable and get more people insured. Extend the expiry age for the term life insurance exemptions to age 80 or 90 because the present exemption was predicated on mortality tables ending at age 100, whereas the new CSO table ends at age 120.

OPTION #4: Tie the expense allowance in the standard nonforfeiture law to realistic expenses, as a matter of equity to both insureds and life insurance companies. It's appropriate to recognize that not only are the expense allowances in the standard nonforfeiture law in need of a complete review, but companies incur different expense levels to issue and maintain policies.

The end result of an up-to-date nonforfeiture statute will be a variety of new and creative life insurance products that aren't constrained by a nonforfeiture law. It's likely that the premiums for some life insurance policies might be reduced, thereby making life insurance more affordable. Further, any improvement in the information conveyed to the public about their policies will be appreciated by both consumers and insurance companies.

Yes, it will be a major challenge to get all interested parties to agree that change to the current standard nonforfeiture law is desirable and then decide on the specific changes to be enacted. But there's no excuse for ignoring that the current statute is out of date.

The real danger lies in not making changes to the standard nonforfeiture law. If regulators and the life insurance industry don't modernize the current law, it would not be surprising to see banks or other financial institutions create a more attractive life insurance look-alike product and simply bypass the traditional life insurance industry. If this were to occur, there would not be a need for the 2010 standard nonforfeiture law. ●