

Product Development Symposium

Regulation and Tax – Life Insurance

Sessions 4B, 6B

May 7, 2004

Presented by:

Kent Scheiwe – Milliman

Greg Mitchell – Lafayette Life

Life Product Development Update

- Status of 2001 CSO Table
- Results of 2001 CSO Survey
- Tax Update of Table

2001 CSO Approval Update

- Number of Approvals
- Expected Approvals
- Magic state #26

Survey

- 12 Companies Participated
- Called companies and asked questions
- Talked to Top Product Actuary

Survey – Timing of Table Implementation

- As quickly as possible
- Priced one WL type product
- Still developing 80 CSO plans
- Haven't done anything yet. Don't want to rush
- Testing has been done, no product pricing yet
- Will begin later this year
- Begin when 26th state approves

Survey – Order of Product Implementation

- My expectations
- Reality

Survey – Order of Product Implementation

- Term & SPWL (completed), 10-pay WL & Par WL (next), then UL & VUL (last)
- Term, WL, UL, VUL (future)
- UL (distant future)
- Par WL (soon), SPUL (next), term (later)
- Final Expense (completed), UL & WL & Term (in that order)

Survey – Order of Product Implementation

- Term (soon), UL w/2nd guar & WL (follow), VUL (in four years)
- No order determined yet

Survey - Reasons for Order

- Term pushed back due to reinsurance
- Term not guaranteed so reserve issue minor
- Few advantages for VUL, UL
- UL w/secondary guarantee may benefit

Survey - 2001 CSO State Filing Issues

- Only two companies have filed
- Some states are accepting 2001 CSO products without regulation passed
- No issues with 2001 CSO encountered (other than table not approved yet)

Survey - Product Design Issues

- All products designed to mature at 120
- Concerned about Section 7702 issues

Survey - Administration System Issues

- Few companies have tested
- Vendors say system will work
- Few problems cited. System vendor quickly fixed problems.

Survey - Marketing Dept Reaction to Table

- Pleased with new products
- Only will be pleased if product performs better
- Concerned that companies are using new table as recruiting tool

Survey - Product Results

- More profitable products, higher commissions, or greater benefits (lower premiums)?
- Priced products resulted in:
 - Lower premiums
 - Restored profitability (lower dividends)
 - Restored profitability (lower benefits/reserves)

Survey - Valuation Rate to 4%

- Long-term life rate may lower to 4% in 2005
- Companies thoughts on 4% valuation rate:
 - Already reserve at 4%
 - Not linked to 2001 CSO product development
 - May not care if drops to 4% if returns to 4.5% year later
- Nonforfeiture Law allows one year hiatus

Maximum Valuation Rate for 2005 21+ Year Guarantee

Moody Rate	6.21% (April-June 2004)
12 Month Average	6.21%
36 Month Average	6.79%
Unrounded Rate	4.124%
Rounded Rate	4.00%

Maximum Valuation Rate for 2006 21+ Year Guarantee

Moody Rate	7.87% (July '04 – June '05)
12 Month Average	7.87%
36 Month Average	6.93%
Unrounded Rate	4.376%
Rounded Rate	4.50%

7702 Issues

- ACLI working with Treasury
- Deferral period?
- Rules for guideline premiums and corridor factors?
- Grandfather rule for changes to current policies in force?

SOP 03-1

Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long- Duration Contracts and for Separate Accounts

The Transition from 1980 CSO to 2001 CSO

How?

By NAIC Model Regulation:

Recognition of the 2001 CSO Mortality Table
For Use In Determining Minimum Reserve Liabilities
And Nonforfeiture Benefits Model Regulation

Impacts:

- Valuation Basis
- Nonforfeiture Basis
- Tax Reserve Calculation under IRC Section 807
- Definition of Life Insurance under:
 - IRC Section 7702
 - IRC Section 7702A

Timing:

Valuation and Nonforfeiture

Mandatory Date: January 1, 2009

- Specified in model regulation
- Applies to all new issues in states where adopted
- Adopted by regulation rather than statute in most states
- 23 states have adopted as of 03/31/04
- Permitted for use in state once adopted

Tax Reserves

Mandatory Date: January 1, 2008 ??

QUITE LIKELY

- IRC Section 807(d)(5) gives “Prevailing Table” rules
 - 807(d)(5)(A) says Prevailing when 26 states permit use
 - 807(d)(5)(B) gives 3 Year Transition Rule
 - “Year of Change” will be 2005 if 26 states by 12/31/04
 - Can use old table till close of 3rd year after change (12/31/2007)

Definition of Life Insurance

Mandatory Date: January 1, 2008 (we think)

- 7702(c) points to 807(d)(5) to set “reasonable mortality” = Prevailing Table
- 7702A points to 7702 for computational rules and thus also points to 807(d)(5)
 - 807(d)(5)(A) will make prevailing this year
 - Prevailing Table for a contract is most recent table permitted for use in 26 states as of the contract issue date
 - 807(d)(5)(B) pushes mandatory date to 1/1/2008
 - Depends on interpretation of reference to 807(d)(5)
 - Would seem to include (A) and (B)
 - Pick up 3-year transition in (b)
 - If only (A), would have to use 2001 CSO for 7702 starting with 26th state adoption
 - Seems unreasonable since there are 24 states that do not yet permit use.
 - IRS Guidance expected soon
 - 7702 calculations using 2001 CSO required as of date of 26th state adoption seems unreasonable since there are 24 states that do not yet permit use.

Which version of 2001 CSO?

Safe Bet: Ultimate table for appropriate smoke class

- 807(d)(5)(E) says use the one that “generally yields the lowest reserves”
- The same version would apply for 7702 and 7702A
- Makes sense as basis for valuation as well
- AAA working group report to LHATF said:
 - Ultimate gave lower reserves than Select & Ultimate on an industry wide basis
 - No material difference between Unismoke and Smoke Distinct

When do you introduce 2001 CSO products?

- How about today? (well, where adopted)
 - Some good
 - Typically lower stat reserves required
 - Some not so good *
 - MEC and Guideline Premium levels lower
 - Maximum cash values permitted under the Cash Value Accumulation Test are reduced
 - Lower tax reserves

* The 3-year transition rule in 807(d)(5)(B) gives permission to continue using 1980 CSO but it may be assumed to follow the model regulation plan-by-plan adoption rule in Section 4A. Alternatively, 1980 CSO could be used for 807(d), 7702 and 7702A purposes until 1/1/2008. OPINIONS??

- Wait till last minute: 1/1/2009
 - Status quo on issues prior to 2008
 - 2008 issues of 1980 CSO contracts have some problems:
 - Lose some profitability since tax reserves based on 2001 CSO
 - MEC premium reduced since based on 2001 CSO
 - Guideline premiums reduced since based on 2001 CSO
 - Cash Value Accumulation Test products may **FAIL!!**
 - An attained age 99 cash value under 1980 CSO on an LP100 will be greater than the age 99 net single premium under 2001 CSO (for coverage to 100).

Which product line do you move first?

- Term
- Traditional Whole Life
- UL/VUL

Depends on the impact to the particular company and to the line.

Which product line do you move first?

What about TERM?

- Upside:
 - Basic reserves will decline
 - Deficiencies may be reduced
 - Change in slope of table will permit X-factors that better reflect actual experience mortality

- Downside:
 - Reinsurance quotes may not be as good as current rates
 - Tax reserves will decline

- Decision Criteria:
 - If reinsurance driven:
 - At risk of higher rates
 - Any benefit limited to degree retained
 - How many real \$ of profit retained?

 - If high volume company:
 - Reinsurance volume may allow better rates
 - Retained volume makes benefit meaningful to company

- Possible Product Strategies:
 - Reduce premiums
 - Increase profits (or return to desired profitability)

Which product line do you move first?

What about TRADITIONAL WHOLE LIFE?

- Upside:
 - Statutory reserves will decline
 - Must complete by 1/1/2008 or risk failing Cash Value Accumulation Test of 7702

- Downside:
 - Maximum permitted cash values under Cash Value Accumulation Test will decline
 - MEC Premium levels will decline
 - Tax reserves will decline
 - If par, mortality contribution in dividend scale will decline

- Design considerations:
 - Death Benefit focused products benefit more
 - Cash Value focused products benefit less
 - Cash Value Accumulation Test restrictions
 - Contractually extend maturity to 121?
 - Challenging dividend structure for Par

- Cash Value Accumulation Test restrictions
 - Passes as long as Cash Value never above Net Single Premium to fund future benefits under terms of the actual contract
 - Net Single Premium calculation subject to:
 - 7702(b) specifies 4% as the minimum interest rate
 - 7702(b) points to 7702(c)(B)(i) reasonable mortality charges (2001 CSO)
 - 7702(e) specifies maturity between age 95 and age 100
 - So, same definition of maximum cash values except generally lower mortality charges
 - Increase Cash Values prior to paid-up by limiting payment period

- Contractually extend maturity to 121?
 - Opportunity to offer straight forward guarantee of extended maturity
 - If limit payment to age 100, change to cash values of extending maturity from 100 to 121 is relatively small
 - ETI and RPU calculated using 121
 - Note: there is no extended term table – use 2001 CSO
 - Should NOT be an issue with states
 - BUT.... 7702 Cash Value Accumulation Test undefined after 100

- Passes test for cash values through age 100 since age 121 maturity based values will fall below maximum
 - Does it Fail the test today by contractually defining values beyond the scope of the test?
 - What is status of contract once insured crosses age 100?
 - Can we assume federal legislation to update 7702 will occur before then?
- Challenging dividend structure for Par
 - 2001 CSO based on 1990-95 table so much closer to company experience
 - Little mortality margin to contribute to dividend scale
 - Portfolio earned rates have dropped significantly in recent years
 - Little interest margin to contribute to dividend scale
 - Will not meet field expectations
 - May increase premium levels to support scale somewhat comparable to present
- Possible Product Strategies:
 - Minimize premium
 - Long pay period
 - Minimum cash value
 - Change valuation and nonforfeiture basis of current portfolio
 - Keep features essentially the same
 - Return suffering portfolio to expected profitability
 - Have a 1980 CSO product fire sale
 - Push cash value oriented products
 - Emphasize 1980 CSO maximum cash values and MEC premiums

Which product line do you move first?

What about UL?

- Upside
 - Lower Secondary Guarantee Reserve if using Stipulated Premium Design
- Downside
 - Maximum COI rates will decline
 - Maximum Surrender Charges will decline
 - Guideline and MEC Premiums will decline
 - Corridor Factors will Increase
- Uncertainty
 - Tough to say how Model Reg Reserve will move
- How are Secondary Guarantee reserves affected?
 - Stipulated Premium Design should benefit
 - For much the same reasons that term is benefited
 - Shadow Fund Design affected little
 - Reserve methodology likely wind up with much the same result
- How are Guideline Premium and MEC Premium levels affected?
 - Calculation rules in 7702 specify:
 - Greater of 4% (6% for Guideline Single) or interest guaranteed in contract
 - Maturity between age 95 and age 100
 - Reasonable mortality (2001 CSO)
 - So, only change is in mortality
 - Guidelines and MEC generally lower

Changing the interest rate or maturity age would require federal legislation.
Don't hold your breath.

- How are Corridor Factors affected if you elect to use Cash Value Accumulation Test under 7702(b)?
 - Cash Value limited to Net Single Premium based on:
 - Greater of 4% or interest guaranteed in contract
 - Maturity between age 95 and age 100
 - Reasonable mortality (2001 CSO)
 - No other loads
 - Only change is general drop in reasonable mortality
 - This yields generally lower NSP
 - And, higher Corridor Factor (1/NSP)
 - So, more risk amount required

- How are Maximum COI Rates affected?
 - Computational rules in 7702 for Guideline Premiums limit mortality charges to prevailing table rates (2001 CSO)
 - Typically, these have also served as contractual maximums
 - Some states (TX) may require it but most do not
 - 1980 CSO maximums have been generally sufficient
 - But, may be bumping up against maximum for some ages now under 1980 CSO
 - Switch to 2001 CSO as contractual guarantee could require current COI rate reduction at some ages
 - May need to add other fee income to offset lost mortality charges
 - May need to add other non-guaranteed features to restore lost cushion

- How are Maximum Surrender Charges affected?
 - The switch to 2001 CSO will reduce the maximum surrender charge permitted under the UL Model Regulation in most cases
 - Based on reduced value of initial expense allowance

- How are UL Model Regulation Reserves affected?
 - GOOD QUESTION!
 - Probably very little effect on well funded contracts
 - Fall to Cash Value floor
 - Probably some reserve reduction for minimally funded contracts
 - Has anyone tested the impact?

- UL puts you in a bit of a quandary
 - Testing is more complex than the other product lines
 - The eventual conversion to 2001 CSO will likely end up a “start-from-scratch” product due to the breadth of changes
 - It probably offers the least in terms of upside potential
 - The resulting new plan likely be a reallocation of costs with little change to net values

- Possible Product Strategies:
 - If you have a Stipulated Premium Secondary Guarantee probably want to move to 2001 CSO sooner than later
 - Are there reinsurance issues?
 - Market is VERY limited
 - Will quote allow you to keep 2001 CSO benefits?
 - Otherwise, test products of value in the portfolio
 - If significant improvement, develop 2001 CSO version now
 - If little or no change, plan new portfolio for 1/1/2008 introduction
 - Probably not worth taking tax reserve hit on 2008 issue
 - Emphasize 1980 CSO Guideline and MEC levels in pre-2008 sales

Potential Drop in Maximum Valuation Interest Rate

So, you have a 4.5% valuation rate plan.

What are your options?

- Accept the higher reserves
- Reprice 1980 CSO product to meet targets at 4.0%
- Design 2001 CSO 4.0% product

Choose Higher Reserve?

- How much does it cost?
 - Age 45 Male Nonsmoker LP100 1980 CSO Continuous CRVM Reserve
 - 7.5% more reserve in year 2
 - 5.7% more reserve in year 10
 - But, cost is relative:
 - What is the objective?
 - What was the product earning before?
 - What is the net investment income rate?
- What do you have to tell the states?
 - Do you need to:
 - Refile?
 - Informational Filing?
 - Nothing?
 - You are holding higher reserve than in filing

Choose 1980 CSO Repricing?

- Will agents understand?
 - Product performance diminished
 - Will sales also suffer?
- What about admin costs?
 - Administration system updates
 - Illustration system updates
- Still have same Filing questions

Choose 2001 CSO Design?

- You have to do it eventually anyway
- What if some states lag behind in adopting?