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2001 CSO Table—The Road to 2009

by William Carroll

Introduction

Once in a generation a new mortality table becomes the legal standard for statutory reserve liabilities and nonforfeiture benefits for ordinary life insurance in the United States. In December 2002, the National Association of Insurance Commissioners (NAIC) adopted a model regulation formally known as *RECOGNITION OF THE 2001 CSO MORTALITY TABLE FOR USE IN DETERMINING MINIMUM RESERVE LIABILITIES AND NONFORFEITURE BENEFITS MODEL REGULATION*. This action marked the end of an extensive development process and the beginning of a transition period that may extend until 2009.

State laws and regulations specify standard mortality tables to measure life insurance reserve liabilities required to be held in insurance company financial statements filed with state insurance authorities. Mortality tables are also used under state law as standards for minimum cash surrender values and paid-up insurance benefits provided in life insurance policies. Under federal income tax law, these tables affect life insurance company reserve deductions and the definition of life insurance for federal income purposes.

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The 2001 CSO Table

The 2001 CSO Mortality Table was developed by the American Academy of Actuaries working with the NAIC Life and Health Actuarial Task Force (LHATF). The table was based on the 2001 Valuation Basic Table developed by the Society of Actuaries for that purpose. This marks the first time that a major valuation table was developed as a joint project of the AAA and the SOA with the Society acting in its basic research role and the Academy serving in its public interface role. There was extensive liaison between the organizations at every step of the process. Hopefully this will serve as a model for future joint projects.

Like the 1980 CSO Table that it replaces, the 2001 CSO Table is a family of tables. There are nonsmoker/smoker versions, as well as composite versions that do not distinguish by smoking habits. There are gender-blended versions for nonforfeiture purposes that combine male and female mortality rates. There are select and ultimate versions as well as ultimate versions. The select/ultimate tables are presented in the classical format, rather than in the form of select factors used with the 1980 CSO. The length of the select period is 25 years, which is significantly longer than the 10 years used with the older table. There is no new Commissioners' Extended Term (CET) Table to replace the 1980 CET Table; therefore, the new minimum basis for the computation of values related to extended-term insurance benefits will be the 2001 CSO Mortality Table. The volume of insurance continued under extended-term insurance provisions has declined, and the SOA task force did not find sufficient differences in experience under that provision to justify recommendation of a new CET Table.

A complete discussion of the development and extensive analysis of the 2001 CSO Mortality Table, including all the tables in Excel spreadsheet format, may be found on the SOA Web site (*www.soa.org*) in the Report of the American Academy of Actuaries' CSO Task Force. The Society of Actuaries Report on the Valuation Basic Table is also included as an appendix to that report.

The NAIC Model Regulation

The NAIC model regulation sets forth the rules for use of the 2001 CSO Mortality Table.

Authority to adopt the new commissioners' mortality tables by regulation is found in the Standard Valuation Law and the Standard Nonforfeiture Law for Life Insurance. An important exception to this is the state of Florida where legislative action is necessary to authorize adoption of the regulation.

Unlike the 1980 CSO Table, where the smoker/nonsmoker and gender-blended versions were adopted at different times subsequent to the composite table, the 2001 CSO Mortality Table is a complete package. Consequently, the entire enabling regulation is contained in one NAIC model regulation.

That regulation was developed by LHATF after extensive discussion among regulators and industry. Regulators were nearly unanimous and all industry concerns were adequately addressed. Consequently, it should eventually be adopted by all states.

Timetable for Use of Table

Under the NAIC model, companies are permitted to elect to use the 2001 CSO Mortality Table as the minimum standard on a plan-by-plan basis for policies issued on or after January 1 of the year next following or coincident with the effective date of state adoption of the regulation.

Companies must use the 2001 CSO Mortality Table as the minimum standard for policies issued on or after January 1, 2009.

Key Provisions

The flexibility that developed over the past 20 years is continued under the model.

There was never any thought given by LHATF to restricting the flexible use of the smoker/nonsmoker or composite tables. Companies may continue to use either the composite table or the smoker/nonsmoker tables for all valuation and nonforfeiture purposes. Or, companies may use the smoker/nonsmoker tables to determine the valuation net premiums and additional minimum reserves, if any, under Section 8 ("Deficiency Reserves") of the Standard Valuation Law (SVL) and the composite tables for basic reserves and nonforfeiture benefits. This remains optional on a plan-by-plan basis.

Flexibility was not so easily arrived at when it came to flexible use of the ultimate or select/ultimate tables. One leading state actuary believed that a company should not be able to use one form of the table for basic reserves and the other form for deficiency reserves. This issue first arose with the introduction of the 10-year select factors for use with the 1980 CSO table.

The SVL merely says that the table for use in determining the minimum standard is the 1980 CSO with or without 10-year select factors. Soon after adoption of the 1980 amendments to the SVL, the practice of using the ultimate form for basic reserves and the select/ultimate form (the 10-year factors) for "deficiency reserve" testing emerged. When the NAIC adopted the initial version of Valuation of Life Insurance Model Regulation (Regulation XXX) in 1995, it was made clear that the choice of table for basic reserves and deficiency reserves was independent. After much discussion by LHATF, this flexibility was continued.

The 2001 CSO Mortality Tables also apply to Regulation XXX. Actuaries who enjoy details will relish this section of the model. Others will be satisfied to learn that the 2001 CSO replaces the 1980 CSO and everything else remains about the same. An entire section of this model regulation is devoted to this issue. The NAIC staff has painstakingly located every reference in the existing Regulation XXX to a mortality table or rate and has indicated which part of the 2001 CSO Table applies. To oversimplify without much loss of accuracy, parts of the 2001 CSO replace corresponding parts of the 1980 CSO. This is not quite precise because the two tables do not have exactly corresponding parts. (For example, where Regulation XXX permitted 1980 CSO with or without 10-year select factor, but did not permit the 20 year select factors developed for Regulation XXX, the 2001 CSO model permits only the 2001 CSO ultimate table.) Importantly, the use of X-factors with the select 2001 CSO Table is continued for deficiency reserve subject to generally the same conditions.

There was brief, but never serious consideration, of extending the use of X-factors to basic reserves. One new aspect is that the actuarial demonstration required when X-factors are used may not combine the results of tests that utilize the 1980 CSO Mortality Table with tests that utilize the 2001 CSO Mortality Table unless the combination is explicitly required by regulation or is necessary to be in compliance with relevant Actuarial Standards of Practice.

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Companies may use the gender-blended versions of the 2001 CSO Mortality Tables for nonforfeiture purposes. Those with a keen interest in this issue will notice that some of the minor limitations that applied to the use of the 1980 CSO Gender-Blended Tables have been removed. Use of these tables is also optional on a plan-by-plan basis. Protection against violation of the unfair trade practice statute is continued for those that take advantage of the plan-by-plan feature. In response to a request for clarification, new wording was added to clarify that these tables are not permitted by this regulation as the minimum valuation standard. Only a handful of states explicitly provide that gender-blended tables may be used as a valuation standard.

Finally, under an important new provision, use of the 2001 CSO Mortality Tables triggers a requirement that the actuarial opinion filed by companies with the annual statement be based on asset adequacy analysis. This will affect companies that file the alternate form of the actuarial opinion included in the older version of the NAIC Actuarial Opinion and Memorandum Regulation that is still found in most states.

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Unresolved Issues

The American Men (5) Mortality Table never replaced the American Experience Table as the valuation standard in all of the states. Critics of that table pointed out that it was based on the average experience of the contributing companies and, consequently, not adequate for all of the industry. The same issue arose during the LHATF discussions of the 2001 CSO Table. New York advocated that companies be required by the NAIC model regulation to annually file mortality experience data with the states. This would facilitate state review of company mortality experience and deal with the decline in the number of companies participating in the SOA experience studies. LHATF rejected this, choosing instead to rely on asset adequacy analysis to protect against inappropriate use of the new table.

Discussions of this issue have continued in New York. An announcement from the New York Superintendent of Insurance to the New York domiciled companies on this matter is expected shortly. Indications are that the letter will strongly encourage companies to participate in the SOA-LIMRA Mortality Study and indicate that New York will consider a regulatory solution if voluntary participation is not satisfactory. The American Council of Life Insurers (ACLI) also will write an announcement asking its members to consider voluntary participation in the study to avoid a regulatory mandate.

Federal Income Tax Reserves

When the 2001 CSO Mortality Table becomes permitted in computing reserves under the insurance laws of at least 26 states, it will become the "prevailing commissioners' standard table" for reserves under section 807(d) of the Internal Revenue Code. The law provides a full three-year transition period during which the previous prevailing table may be used. For example, if the 26th state adopts the 2001 CSO Model Regulation during 2005 with a permissive date of January 1, 2006, then the 2001 CSO Table would become prevailing on January 1, 2006. Tax reserves for policies issued during 2006-2008 could be based on either the 1980 CSO or the 2001 CSO. For policies issued on or after January 1, 2009, the 2001 CSO Table would apply. It is not coincidental that this hypothetical date coincides with the mandatory use date in the NAIC model. Of course, the state regulators could act more quickly and the 2001 CSO Table could become required for tax reserves before the 2009 state mandatory date.

The 2001 CSO Table, like the 1980 CSO Table, is a family of tables composed of more than one table with options under those tables. Consequently, more than one table meets the criteria for prevailing table. In these cases, section 807(d) calls for use of the table that "generally yields the lowest reserves." The 2001 Valuation Basic Table and the 2001 CSO Mortality Table were developed with this issue in mind. The Report of the American Academy of Actuaries' CSO Task Force says essentially the following about the relative magnitude of reserves under the available options:

- Reserves on the Ultimate Table are generally less than Reserves on the Select/Ultimate Basis.
- Reserves on the Smoker/Nonsmoker

Basis are generally the same as reserves on the Composite Basis.

This is the same fact pattern that was presented for the 1980 CSO Table. Consequently, it is reasonable to expect that tax reserves would continue to be based on the ultimate table and that either smoker distinct or composite tables could be used for tax reserves.

Definition of Life Insurance

Section 7702 of the Internal Revenue Code provides that in order to be a life insurance contract under the Internal Revenue Code, the contract must be a life insurance contract under applicable law and must also meet one of two alternative computational tests. Both of these tests include an element for "reasonable mortality charges." The code further provides that reasonable mortality charges shall not (except as provided in regulations) exceed the mortality charges specified in the prevailing commissioners' standard tables. The Department of Treasury Notice 88-128 set forth "interim rules" for the determination of the reasonable mortality charge requirement. Specifically, the Notice provided a safe harbor for the use of the 1980 CSO Table that taxpayers continue to rely on.

Unlike section 807, section 7702 has no explicit transition provisions that would provide for an orderly transition in the prevailing table. The ACLI concluded that the most immediate need for guidance relates to transition rules and the effect of the new tables on existing contracts. In October 2002, the ACLI requested that Treasury provide the following transition guidance:

1) The provisions of Notice 88-128 with certain clarifications shall continue to apply to all life insurance contracts issued before January 1, 2009 that do not utilize the 2001 CSO Tables in the underlying computations.

2) For contracts issued using the 2001 CSO Tables, there is a safe harbor of 2001 CSO Tables for all reasonable mortality charge computations to the same extent as Notice 88-128 provided a safe harbor for use of 1980 CSO, except that the reasonable mortality charges for a contract cannot exceed the amount of mortality charges guaranteed under the contract.

3) After December 31, 2008, the only safe harbor will be the 2001 CSO Tables for newly issued contracts. Existing contracts can continue to use 1980 CSO to the same extent as provided under Notice 88-128.

4) Contracts using 1980 CSO Tables that undergo material changes or adjustment events can continue to use their existing mortality tables. In the case of an exchange of a contract for a newly issued contract, however, the date of issue of the new contract will determine the appropriate mortality table. This exception should apply only in the case of an actual exchange and not in situations where an insurance contract merely undergoes a modification, such as the addition or removal of a rider.

The ACLI met with representatives of the Department of Treasury in late 2002 to discuss this request for guidance. While no formal action was taken regarding transition courses, ACLI remains optimistic that work on the requested guidance will proceed this year.

Current State Activity

As this article is being written, only a few months have passed since the NAIC adopted the model in December 2002, so it should not be surprising that only two states, New Mexico and Texas, have adopted the regulation and only three others, Oklahoma, Pennsylvania and Utah, have issued proposals. Bureaucratic machinery moves slowly. An apparent slow start should not be taken as an indicator of future developments. When the number of states adopting the rule reaches the 26 required to make the new tables prevailing for FIT purposes, pressure to complete the remaining states will naturally arise. Sooner than we realize, 2009 will be upon us and the implementation effort that lies ahead will be history. ☐

William Carroll, FSA, MAAA, is an actuary for the American Council-Life Insurers in Washington, D.C. He can be reached at wiilliamcarroll@acli.com.