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SEAC Secondary Guarantees Debate

The following article is presented as a reasonable transcription of a staged debate at a recent meeting of the Southeastern Actuarial Club in Key West, Florida. The topic of the debate was how appropriate are no-lapse secondary guarantees on universal life insurance products.

Resolved: UL products providing secondary guarantees are not required to provide nonforfeiture benefits related to the secondary guarantees.

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Moderator: In order to frame the debate, I will spend just a few moments going over some definitions and issues at the heart of the matter. The definition of a secondary guarantee is a policy provision that keeps a universal life (UL) policy in force, even if the cash surrender value is zero. The Primary Guarantee in a UL plan limits the maximum Cost of Insurance Rates and Expense Charges and the minimum Credited Interest Rate. The policy says as long as the cash surrender value is at least as great as the monthly deduction, the policy will stay in force. This was the only

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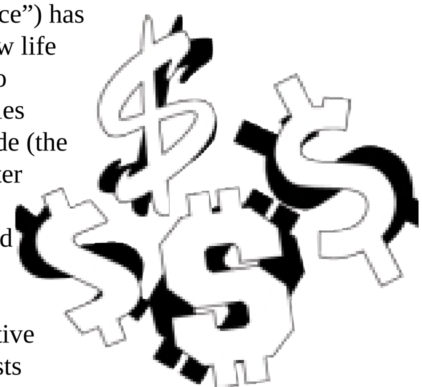
Revenue Procedure 99-27

by Brian G. King & Christian J. DesRochers



The Internal Revenue Service (the "Service") has released the details of a program to allow life insurers to correct inadvertent failures to comply with the modified endowment (MEC) rules under section 7702A of the Internal Revenue Code (the "Code"). Under the program, the Service will enter into closing agreements that will provide that contracts for which premiums have been collected that exceed the aggregate 7-pay limit will not be treated as MECs.

As announced, the revenue procedure is effective as of May 18, 1999, but is limited to relief requests received on or before May 31, 2001. To enter into a closing agreement under the revenue procedure, a life insurance company must file a ruling request, accompanied by a closing agreement. The company must also pay a "toll charge" computed as described in the revenue procedure. In addition, the contracts covered in the closing agreement must be brought into compliance with section 7702A, by increasing the death benefits or by returning the excess premiums and earnings on those premiums to the policyholder.

Because the revenue procedure is generally available to a life insurance company only once (except in limited instances), companies may decide to defer filing their ruling request to a date closer to the expiration date of the revenue procedure (May 31, 2001). However, before a company can decide when to file its ruling request, a significant work effort must first be undertaken, which at a minimum includes the following:

- Determine which contracts meet the definition of "inadvertent MEC."

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guarantee typically found in the first generation of UL plans.

A Secondary Guarantee in a UL plan expands the "no-lapse" protection. When the second generation of UL plans with surrender charges appeared in the mid-'80s, policy forms changed. They said during some initial period (e.g., five years), even if the cash surrender value was less than the monthly deduction, the policy would stay in force as long as the owner paid a minimum premium. The purpose of this additional, no-lapse provision was to keep the policy in force while the owner paid enough premiums to cover the surrender charge. That was the first type of secondary guarantee.

Since then, the length of time the policy will stay in force has expanded well beyond the surrender charge period and the requirements and conditions have gotten tougher creating the more meaningful secondary guarantees we have today.

Today, in five states—Texas, Massachusetts, Pennsylvania, New Jersey, and New York—it is not possible to have UL policies with long, meaningful, and affordable secondary guarantees that are available in the other states. The heart of the issue is an interpretation of what the standard nonforfeiture law (SNFL) requires. Except for New York, individual state nonforfeiture laws are not materially different than the SNFL.

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Some of these states are requiring companies to provide cash values at least as great as the SNFL requires for a level term policy of the same duration as the secondary guarantee. As an example consider a UL policy that, in addition to its primary guarantees, says if the owner pays a specified premium, the policy will stay in force until the insured's age 90, regardless of what happens to the cash surrender value. Using actual numbers for an age 50 insured, a UL policy with a 40-year guarantee at an $11,820 premium naturally produces a 10th year cash value of $82,527. The 10th year minimum cash value on a 40-year term policy is $180,031. The term cash value calculation assumes a premium of over $25,000. In order for the UL policy's cash value to equal that of the term, the company would have to credit 14% interest.

California was the sixth state. However, on November 13, 1998 the California Department of Insurance relaxed its opposition to secondary guarantees provided the company makes additional disclosures at the point of sale highlighting the fact that a traditional policy might have higher nonforfeiture values at the expense of a higher premium.

Question 1: Are secondary guarantees good for the public?

Affirmative: Yes. There can be no doubt that they are good for the public since they give the consumer a valuable option and there is no explicit charge. The company can afford to provide the guarantee because of the conservatism inherent in the contractual guaranteed values and the added benefit of increased and more predictable premium revenue. This is why they are willing to guarantee a premium less than guaranteed interest and COI charges would suggest. Consumers can

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still stop and restart premium payments; however, if they agree to more predictable behavior they will receive an added benefit.

The sales misconduct problems that have plagued the life insurance industry in recent years have involved the presentation of life insurance as a savings vehicle and/or false promises of account value accumulation. These problems have resulted from too much emphasis on the illustration of current values. Secondary guarantees focus on long-term guaranteed death benefit protection, which is the other end of the spectrum from what has gotten the industry into so much trouble. Simply, there is very little possibility of misleading sales practices or consumer confusion with secondary guarantees.

Of course, none of this applies if there are additional nonforfeiture requirements. Introduction of these would require designated premiums to be increased to levels that would not be attractive to consumers. In fact it is quite probable that companies would not even offer the benefit.

Negative: No. At present time, secondary guarantees are a detriment to the public as a whole. There are two reasons for this. The first goes all the way back to Massachusetts in 1861 when that state's legislature enacted the first nonforfeiture law. This is really the first instance in U.S. history where elected officials felt the need to infringe upon the individual's ability to contract. This "Public Welfare" legislation was felt to be for the greater good of the public as a whole. The nonforfeiture concept calls for some pre-funded benefits to persist in the event of a lapse in premium. With today's secondary guarantees, a policyholder could pay the required premium for many years, be late with a single payment, and forfeit all the no-lapse protection the secondary guarantee was to provide. Even if cash nonforfeiture benefits are not required, equity demands something more than a complete forfeiture. The problem with secondary guarantees is that they are wonderful for a small segment of the population that is well educated and informed about the array of insurance products available and the actuarial issues surrounding nonforfeiture and the cost/benefit tradeoff of lower premiums and lower nonforfeiture benefits. I admit that it is unfortunate that this tiny fraction of the population is inconvenienced for the greater good of the whole.

> ***"The problem with secondary guarantees is that they are wonderful for a small segment of the population that is well educated and informed about the array of insurance products available and the actuarial issues surrounding non-forfeiture and the cost/benefit tradeoff...."***

The second reason they are bad is because current legislation is unable to address the complex reserving issues they present. The current valuation law does not force companies to establish adequately conservative reserves for them. When XXX is ultimately enacted, it will address the situation somewhat; however, it contains certain political concessions that weaken its ability to ensure solvency. Inappropriately reserved products weaken companies. This is always a detriment to the public good. Furthermore, the current nonforfeiture model law was drafted before secondary guarantees were popular and therefore did not specifically name them. Those who think the model law was purposely designed to permit secondary guarantees without associated nonforfeiture benefits are misguided.

Rebuttal to Question 1: Are secondary guarantees good for the public?

Affirmative: No company is forcing anyone to accept the conditions necessary for invoking secondary guarantees. They are merely offering them as an additional option, thus giving the consumer more choices. Furthermore, there is no deficiency in the valuation standard. The valuation actuary law assures that no company will be weakened because the valuation actuary has a professional obligation to ensure that the reserves established be adequate.

Negative: Well, obviously the valuation actuary law will not catch everything, because if it could, we would not need XXX. In the absence of XXX, increased premiums that fund nonforfeiture benefits would create an additional reserve requirement under the section that requires reserves at least as high as cash values. This would create a reserve standard that is more conservative and would approach the level of prudence needed to ensure solvency. The fact that secondary guarantees offer an additional option is precisely the point why they are bad. A majority of consumers already do not under stand the options they are currently presented. One more can only add to the confusion.

Question 2: Are nonforfeiture benefits related to secondary guarantees required by law?

Negative: Yes. They are required by both the letter and the spirit of the law. There are two theories on this. The Texas Department of Insurance feels the Texas law is very clear that all guarantees are to be included in the calculation of the cash value. The California Department of Insurance concedes that secondary guarantees are not explicitly cited in California's nonforfeiture law; however, the product filing law has language stipulating that the product must meet the commissioner's expectations. This gives the commissioner broad authority to use his discretion to interpret whether a product meets the expectations of the nonforfeiture law. The product filing law is another example of where an individual's right to contract is diminished. The reason for this is that basic contract law assumes the parties are all on a roughly equal footing. It is naïve, to say the least, to pretend that any given individual could negotiate from an equal position as that of a gigantic insurance company. And while secondary guarantees are not included by name in the nonforfeiture law, they are certainly included in the spirit of the law.

Affirmative: The law does not require additional nonforfeiture values in respect of secondary guarantees. Unlike some reserve laws, there is no requirement in the standard nonforfeiture law to split the policy into segments. The NAIC model UL regulation specifically covers nonforfeiture values for UL, and it does not require anything additional for secondary guarantees. This would be the end of the discussion if there were uniform adoption of this regulation. Despite the lack of a uniform approach, the overwhelming consensus is for nonforfeiture benefits on UL to be based on a retrospective accumulation with limits on the charges in the policy. The disparity seems to be caused because we are a state-regulated industry with the regulatory authority set up in such a way that individual commissioners have discretion to interpret laws. I would have thought that the intent of such discretionary authority was to expedite the enforcement of laws. However, what we seem to have here is a situation where it is being used to create a new law. Furthermore, it is a new law that can cause inequitable treatment of consumers. You could have two identical policies in all regards except that one has a secondary guarantee and the other does not. The policy with secondary guarantees would have higher nonforfeiture benefits. But what happens when that policyholder stops the premium payment abruptly? The secondary guarantee goes away and a cliff in nonforfeiture benefits is created.

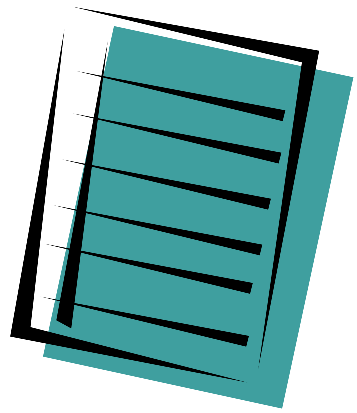
Rebuttal to Question 2: Are nonforfeiture benefits related to secondary guarantees required by law?

Negative: Speaking of cliffs, if 47 insurance commissioners were to jump off a cliff, would that mean the other three would be required to as well? Losing the value of the nonforfeiture benefit is no different from losing a potential interest bonus by surrendering in the 11th month of the 19th year. It is different from taking away a declared dividend because once a dividend is paid, it is not contingent upon policyholder behavior anymore.

Affirmative: Nonforfeiture value cliffs would cause enormous concern for the industry. Dividends and UL fund values progress in a steady, smooth fashion that is understandable to policyholders. Nonforfeiture cliffs would not be understood by the general public and would create a new round of litigation nightmare.

Question 3: What types of reserves are required for secondary guarantees under SAP and GAAP accounting?

Affirmative: The theoretical reserve that is required for a secondary guarantee is the present value of the expected utilization of the benefit. Under GAAP accounting, this can be incorporated in the FAS 97 projections. On a statutory basis, I believe that this can be covered



under the valuation actuary law. I strongly disagree with a point made earlier, that XXX is related to a failure in the valuation actuary law. For statutory accounting, the valuation actuary's cash flow testing clearly can be structured to ensure adequate reserves.

Negative: From a regulatory perspective, I do not care about GAAP. That is for the accountants and SEC personnel to determine. I will say that if the commissioner deems nonforfeiture values are required, they must be reflected in the benefit reserve. I have already mentioned that the current valuation law is deficient with respect to its ability to address secondary guarantees. XXX will address this somewhat with its segmentation language. Higher nonforfeiture values will address the situation somewhat by requiring reserves as high as nonforfeiture values, though, admittedly, this is a "back-door" method of ensuring solvency. The valuation actuary law

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has the ability to address the issue as well; however, few valuation actuaries test the question "what if my mortality assumption is fundamentally wrong?"

Rebuttal to Question 3: What types of reserves are required for secondary guarantees under SAP and GAAP accounting?

Affirmative: This so-called "back-door" method is the inherent problem. It is up to us actuaries to promote our ability to adequately assess the inherent risks in a product and establish adequate

reserves. We should not have the situation clouded by piecemeal, disjointed regulations that attempt to stumble into the correct answer through the back door.

As regards the valuation actuary's work, this should indeed include sensitivity testing of mortality assumptions, especially if this is a primary risk factor. It is agreed that in all likelihood very few valuation actuaries test disaster scenarios under such mortality sensitivity tests. However, there is no reason to believe that this is in any way inconsistent with the sensitivity testing of other economic scenarios. Furthermore, such disaster scenarios would impact much more than just secondary guarantees. Having said this, it has to be noted that there are no examples of company insolvencies arising out of long-term mortality guarantees.

Negative: The term wars of the '80s taught us some valuable lessons regarding aggressive pricing. Fortunately, the valuation laws protected the companies because the products were traditional. That is no longer the case, and we may be condemned to repeat those mistakes because of faulty memory. Just because the valuation cash flow testing indicates a company only needs $100 million when the standard valuation law indicates $150 million does not mean the extra $50 million is unneeded.

There is no free lunch. These secondary guarantees are valuable benefits that create a significant liability. The greatest product, from a marketing standpoint, is one that has a perceived value that is very high, but a very low actual value. And some might believe that secondary guarantees have a very low actual value, but that is because they are not valuing the cost of the liability correctly.

Question 4: Can we ever ignore the letter of the law? Can we ever ignore the spirit of the law?

Negative: The answer to both is absolutely, unequivocally, never! I was actually in a situation where a charity needed to file an actuarial opinion regarding the valuation of a block of gift annuities. A member of the insurance commissioner's staff told me over the phone that a full-blown opinion and the required cash flow testing was only needed for real insurance companies. A charity could get by with just a certification letter. Well, we felt the law was clear, so we refused the assignment.

Affirmative: I agree that it is wrong to ignore either the letter of the law or the spirit of the law, but think that we need to examine precisely what this means. This is particularly important when we have a situation where commissioners have the discretion to "interpret" laws. Clearly this creates an environment where people will want to try to influence this interpretation.

Insurance laws relating to valuation and nonforfeiture are out-of-date. They are not necessarily applicable to the types of products being sold today, nor to the economic environment of the past 25 years, nor to the mortality environment on fully-underwritten business of the last ten years. The laws are inconsistently applied between states and some times within states. We sometimes have the absurd situation where a state insurance department disapproves a product for a specific reason but allows prior approved products that have the offending feature to remain available for sale. On valuation, we may be heading for the biggest concern of all where one state (and a small one at that) can dictate the reserves of term policies across the country. On standard nonforfeiture, it does not make sense to have minimum nonforfeiture to protect consumers but at the same time, allow some companies to gouge consumers when it comes to value for money.

Given the inadequacies, the gray areas and the commissioner's ability to "interpret," it is inevitable that the letter of the law will be pushed to the limit. I am not sure that in this environment, there is anything wrong with this, provided you follow the spirit of the law. In following the spirit of the law, it is important to take a macro view. So, for example, the spirit of the standard valuation law is to ensure adequate reserving for future liabilities under somewhat adverse conditions to minimize the chances of insolvency; and the spirit of the standard nonforfeiture law is to ensure fair treatment for policyholders who choose to discontinue premiums but may have prefunded future benefits.

Rebuttal to Question 4: Can we ever ignore the letter of the law? Can we ever ignore the spirit of the law?

Negative: In Europe, the insult that is hurled toward the United States is that we are a nation of laws, not a nation of men. The sexist nature of the insult notwithstanding, I have to say that I agree. A lot of people in this country have achieved temporary success by swooping in and taking advantage of someone or something. Most of the time these people manage to stay out of jail, but not always. Unfortunately, the people who stay out of jail do a tremendous disservice to the industry by eroding public confidence in our insurance institutions.

In my opinion, the rules are pretty clear. We sell insurance products to people who are risk averse that are priced to return a fair profit. We are restricted in our capital structures so as to ensure we will be able to keep our promises. Finally, in a perfect world, all negotiators would be on an equal footing, and there would be no restrictions on what types of products can be sold. However, this is not a perfect world, and insurance companies are not on an equal footing, with their policyholders. A pragmatic regulatory decision was made mandating nonforfeiture benefits in certain instances because regulators deemed the benefits received by people who need term to 100 do not outweigh the suffering that would be caused if the general public had access to these products. Now, it is not necessarily always going to be that way, but until the law is changed, I feel we should respect the decision of the regulators. If you feel the general public is now so sophisticated that the amount of abuses would be minimal, then work to change the law. Do not settle for a short cut.

"If secondary guarantees truly are in the public's best interest, then market forces will eventually coerce a uniform adoption of policy across the nation as our laws evolve....It is incumbent upon us always to remember that as professionals we must respect the opinion of the commissioner...."

Affirmative: Given my British background there is a certain irony in me defending the American approach to legal matters. I have never personally come across the suggested insult that the United States is a nation of laws, not a nation of men. However, I can tell you that Europeans are dumbfounded that U.S. insurance companies are subject to 50 different regulatory jurisdictions, and each one has its own discretion. The bureaucratic inefficiencies are mind-boggling. In this type of an environment, pushing the gray areas of the law is inevitable.

Summary Paragraphs:

Negative: Our opening resolution about secondary guarantees being in the public's best interest is really a subjective statement. Its truth varies from state to state at the discretion of each state's legislature and insurance commissioner. But its truth also varies with time as California's recent change in policy has demonstrated. Some commissioners currently feel that they are a detriment, and I have tried to illustrate some of the reasons why. If secondary guarantees truly are in the public's best interest, then market forces will eventually coerce a uniform adoption of policy across the nation as our laws evolve. If secondary guarantees lead to greater consumer misunderstanding and disappointment, then the states that proceeded cautiously will have protected their citizens better than the rest. Irrespective of the ultimate outcome, it is incumbent upon us always to remember that as professionals we must respect the opinion of the commissioner in each jurisdiction we operate. This means there are no short cuts and there is no pretending to see gray when the commissioner says it is black and white. If you feel the law is wrong, work within the system to change the law; do not try to figure out a way around the law.

Affirmative: In summary, what we have is a situation where the vast majority of states allows secondary guarantees. The fact that they are not available in some states penalizes the consumers in those states and may even give rise to applicants crossing state lines to get the benefit. Clearly if there is any concern about consumers understanding the tradeoff with nonforfeiture benefits, then this can be solved by following what California has recently done. Just as with their approach to XXX (where they issued bulletin 96-9), California's approach here provides a solution within the existing legislative framework.

Tables from Revenue Procedure 99-27

Example 1:
The Death Benefit is $180,000
The contract is subject to the .5 distribution frequency factor

Contract Year	Premium Paid	Cumulative Prem. Paid	7-Pay Limitation	Cumulative 7-Pay	Earnings Rate	Overage	Earnings Base	Overage Earnings	Prem. Paid as % of 7-Pay
1991	10,000	10,000	10,490	10,490	9.2%	0.00	0.00	0.00	95%
1992	10,750	20,750	10,490	20,980	8.6%	0.00	0.00	0.00	102%
1993	10,800	31,550	10,490	31,470	7.5%	80.00	80.00	6.00	103%
1994	10,700	42,250	10,490	41,960	8.3%	290.00	296.00	24.57	102%
1995	11,500	53,750	10,490	52,450	7.8%	1,300.00	1,330.57	103.78	110%
1996	11,000	64,750	10,490	62,940	7.7%	1,810.00	1,944.35	149.72	105%
1997	10,000	74,750	10,490	73,430	7.5%	1,320.00	1,604.07	120.31	95%

Cumulative Overage Earnings	404.37
Distribution Frequency Factor	0.5
Applicable Percentage	36%
Amount Payable	72.79

Example 1a — Variable Contract
The Death Benefit is $180,000
The contract is subject to the .5 distribution frequency factor

Contract Year	Premium Paid	Cumulative Prem. Paid	7-Pay Limitation	Cumulative 7-Pay	Earnings Rate	Overage	Earnings Base	Overage Earnings	Prem. Paid as % of 7-Pay
1991	20,980	20,980	10,490	10,490	25.4%	10,490.00	10,490.00	2,664.46	200%
1992	10,490	31,470	10,490	20,980	5.9%	10,490.00	13,154.46	776.11	100%
1993	10,490	41,960	10,490	31,470	13.9%	10,490.00	13,930.57	1,936.35	100%
1994	10,490	52,450	10,490	41,960	-1.0%	10,490.00	15,866.92	(158.67)	100%
1995	10,490	62,940	10,490	52,450	23.0%	10,490.00	15,708.25	3,612.90	100%
1996	10,490	73,430	10,490	62,940	14.3%	10,490.00	19,321.15	2,762.92	100%
1997	10,490	83,920	10,490	73,430	17.8%	10,490.00	22,084.08	3,930.97	100%

Cumulative Overage Earnings	15,525.04
Distribution Frequency Factor	0.5
Applicable Percentage	36%
Amount Payable	2,794.51

Example 1b - Material Change (Year 5)
The Death Benefit is $180,000
The contract is subject to the .5 distribution frequency factor

Contract Year	Premium Paid	Cumulative Prem. Paid	7-Pay Limitation	Cumulative 7-Pay	Earnings Rate	Overage	Earnings Base	Overage Earnings	Prem. Paid as % of 7-Pay
1991	10,000	10,000	10,490	10,490	9.2%	0.00	0.00	0.00	95%
1992	10,750	20,750	10,490	20,980	8.6%	0.00	0.00	0.00	102%
1993	10,800	31,550	10,490	31,470	7.5%	80.00	80.00	6.00	103%
1994	10,700	42,250	10,490	41,960	8.3%	290.00	296.00	24.57	102%
1995	11,500	53,750	10,490	52,450	7.8%	1,300.00	1,330.57	103.78	110%
1996	Add Rider	0		2,450					
1996	11,000	11,000	2,450	2,450	7.7%	8,550.00	8,684.35	668.70	449%
1997	10,000	21,000	2,450	4,900	7.5%	16,100.00	16,903.05	1,267.73	408%

Cumulative Overage Earnings	2,070.78
Distribution Frequency Factor	0.5
Applicable Percentage	36%
Amount Payable	372.74

Example 2:
The Death Benefit is $180,000
The contract is subject to the .5 distribution frequency factor

Contract Year	Premium Paid	Cumulative Prem. Paid	7-Pay Limitation	Cumulative 7-Pay	Earnings Rate	Overage	Earnings Base	Overage Earnings	Policy Loan	Cash Value
1991	10,000	10,000	10,490	10,490	9.2%	0.00	0.00	0.00		
1992	10,750	20,750	10,490	20,980	8.6%	0.00	0.00	0.00		
1993	10,800	31,550	10,490	31,470	7.5%	80.00	80.00	6.00		
1994	10,700	42,250	10,490	41,960	8.3%	290.00	296.00	24.57		
1995	11,500	53,750	10,490	52,450	7.8%	1,300.00	1,330.57	103.78	3,000	58,500
1996	11,000	64,750	10,490	62,940	7.7%	1,810.00	1,944.35	149.72		
1997	10,000	74,750	10,490	73,430	7.5%	1,320.00	1,604.07	120.31		

Cumulative Overage Earnings	404.37
Total Income	14,500.00
Proportionate Share Alloc. to Tax Dist.	83.66
Distribution Frequency Factor	0.5
Applicable Percentage	36%
Amount Due on Overage Earnings	57.73
Tax and Interest Due on Distribution	1,617.74
Total Amount Payable	1,675.47