SOCIETY OF ACTUARIES Product Development Section

Product Matters!

ISSUE 74 | JUNE 2009



# Risk Based Pricing—**Risk Management at the Point of Sale**

*by Dominique Lebel*

By far, the most common primary pricing measure is the statutory internal rate of return (IRR). The 2008 Tillinghast Pricing Methodology Survey showed that this was the pricing measure used by 57 percent to 82 percent of respondents, depending on the product. No other pricing measure came close.

The statutory IRR pricing objective is based on achieving a rate of return in excess of the company's hurdle rate, where the hurdle rate is often based on a company's overall cost of capital. While statutory IRR is a useful pricing metric, it is not perfect.

The hurdle rate typically does not vary by product. But different products have different levels of risks. Does a product with a higher pricing IRR create more shareholder value than a product with a lower pricing IRR? Not necessarily—it depends on the risks inherent in each product.

Products are often priced under the implicit assumption that arbitrage opportunities exist. Asset risk premiums (e.g., credit spreads in excess of assumed defaults, and equity risk premiums) are capitalized and are treated as earned before insurers/shareholders are released from risk. If insurers believe that these arbitrage opportunities exist, why not just borrow at the insurer's credit rating and invest in riskier assets rather than manufacture and distribute insurance products?

Consideration should be given to pricing products such that all risks undertaken are measured in an objective and consistent way.

CONTINUED ON PAGE 5


# Product Matters!

ISSUE 74 | JUNE 2009

*Published by the Product Development Section of the Society of Actuaries*

This newsletter is free to section members. Current-year issues are available from the communications department. Back issues of section newsletters have been placed in the SOA library and on the SOA Web site *(www.soa.org)*. Photocopies of back issues may be requested for a nominal fee.







**Editors**
Kenneth E. Joyce, Co-Editor
p: (781) 213-6224
e: *ken.joyce@milliman.com*

Dominique Lebel, Co-Editor
p: (415) 836-1081
e: *dominique.lebel@towersperrin.com*






## Articles Needed for the Next Issue of *Product Matters!*

Please email your articles to Ken Joyce or Dom Lebel by July 15, 2009.

Chairperson's Corner

# **When Change Happens** All At Once

*by Robert Stone*

Robert P. Stone, FSA, MAAA, is a consulting actuary with Milliman Inc. He can be reached at rob.stone@ milliman.com.

What do you get when you cross an elephant with a jar of peanut butter?

**Answer:** an elephant that sticks to the roof of your mouth.

Isn't it easy to appreciate the simplicity of jokes like that?

Well then … what do you get when you cross public mistrust of insurance companies with high unemployment, volatile equity markets, companies teetering on the brink of ruin, and surplus issues for some of those that are stable?

**Answer:** the potential for sweeping product changes.

And that's no joke at all.

It's almost unbelievable, the change that's been wrought on the economic and insurance landscape over the past year. The effect this decline has had on the asset and liability side of many insurance company financial statements is equally difficult to comprehend, at least until you see the hard numbers.

Let's review a bit of the carnage:

Equity declines pound variable annuity writers, some having significant guaranteed living benefit exposure. Required increases in surplus, along with hits to income, create a double whammy for under-hedged books of business. For those that are hedged, costs increase substantially with the roiled markets.

Severe declines in asset values, the result of mortgage-backed security woes and increases in credit spreads, pinch surplus levels in many companies. Some companies are downgraded (not only for this reason) and others are forced to look quickly for cash infusions or divestiture opportunities.

The company surplus squeeze and increasing difficulty in finding surplus-relief solutions force companies to review their ability and willingness to pursue ultra-competitive term and universal life with secondary guarantee products.

The insurance industry finds itself a frequent target of media criticism as a barrage of unflattering stories on insurance company woes strike a blow at public trust.

As unpleasant as those descriptions are, they are far from a complete or detailed list of the challenges we face. Nonetheless, they provide a backdrop for some of the potential changes in insurance products that may already be coming.

For variable annuities, it seems doubtful that the appetite for offering the guarantees so popular in the last few years will remain at 2007 levels, at least at 2007 prices. The benefits themselves may become less aggressive and/or prices may increase. This is completely separate from any discussion of how interested the insurance-buying public continues to be in variable annuities (which is no guarantee itself).

CONTINUED ON **PAGE 4**

Price-oriented protection products like guaranteed level term and universal life with secondary guarantees may undergo changes. With fewer cost-effective means to reduce the surplus strain associated with reserve levels of the most competitive products, it is likely that premium levels will increase and/or guarantee periods will become shorter. This process has already started at the time this article is being written.

It's hard to put a finger on the effect damaged public trust will have on insurance product. Will it affect which companies get sales? Will certain products be more or less desirable? Does the perceived need for life insurance coverage mean this business is less affected by trust issues than annuities, which often compete with deposit products outside the insurance industry? Does heightened media coverage lead to calls for more regulation? New regulation could clearly change product—ask indexed annuity marketers about the SEC and 151a.

And what do ratings changes mean for the insurance market? For example, single-premium immediate annuities (SPIAs) have enjoyed steady growth over the last several years as marketing fervor and consumer need have increased together. Will a future public view a SPIA purchase as less of a price-driven commodity and more of a long-term contract that requires financial stability in the providing company? If so, it seems likely that a similar thought process would enter the mind of life insurance buyers, especially those looking at permanent insurance.

Maybe this is all overstated. Many of the issues addressed above have always been a part of the insurance industry dynamic. It doesn't take much of a change in emphasis, however, for the balance of an existing dynamic to switch a market's focus from price to long-term carrier viability.

For companies perceived to be on the wrong side of any viability determination, that's far from a joking matter.

## Risk Based Pricing

Risk based pricing (also known as market consistent pricing) addresses some of the shortcomings of traditional pricing methods by building on modern financial and economic concepts. It differs from traditional pricing methods in the following respects:

- The discount rate is set to reflect the risks inherent in each product.
- Credit spreads and equity risk premiums are earned as insurers/shareholders are released from risk.
- The costs of options and guarantees are valued in a manner that is consistent with how they are valued in the financial markets.

Under market consistent valuation methodology, if a replicating asset portfolio can be found that exactly matches a set of liability cash flows, then the value of the set of liability cash flows is equivalent to the value of the replicating asset portfolio. This would involve discounting each cash flow with the discount rate that would be used to value the cash flow in the capital markets. An equivalent approach is typically used for practical purposes. Under this approach, the cash flows are risk-adjusted such that all assets earn risk free or near risk free rates (e.g., swap rates) and all cash flows are discounted using these same rates (for stochastic simulations, risk neutral scenarios are used). The use of risk free or near risk free rates is based on the assumption that policyholder liabilities are certain to be paid. An adjustment for own credit risk could theoretically be made to the risk free rate however. Other adjustments to the risk free rate could be made when markets are dislocated. This is currently an evolving topic.

Typically, for each product, a value of new business (VNB) is determined which reflects the value to shareholders created through the activity of writing new business.

VNB = Present value of future profits after tax—time value of financial options and guarantees—frictional costs of required capital[1]—cost of non-hedgeable risk.[2]

Risk based pricing provides a robust, transparent and objective economic perspective on new business profitability that is consistent across products. If the VNB is greater than zero, the return is greater than the market price of the risks undertaken. A VNB less than zero reduces shareholder value.

While a positive VNB is necessary to increase shareholder value, it may not be sufficient. Product charges (e.g., premiums) should be set such that the overall value of new business generated (based on anticipated sales volume) maintains the franchise value of the company, which could be approximated as the market capitalization of the company less its embedded value. This is where management has a significant role to play. A VNB of zero determines the minimum price for taking risk, but the final product charge requires management input. For example, product charges need to be balanced with sales volumes and, for a company that is capital-constrained, capital efficiency needs to be factored into the new business pricing process.

Additional metrics commonly used include:

- Profit margin: VNB/PVP, where PVP equals the present value of premiums.
- Implied discount rate: The discount rate such that the traditional value of new business equals the VNB. This is sometimes used to compare the relative level of risk between products.

## Winners and Losers

Some products will perform better than others under a market consistent framework. Results will vary depending on:

- The level of guarantees (e.g., minimum interest rate guarantees or variable annuity/segregated fund guarantees).
- The amount of asset risk borne by insurers/shareholders (e.g., the credit quality of assets).

CONTINUED ON PAGE 6

1 Typically includes costs related to investment expenses and taxation.

2 Typically equal to the present value of 0 percent to 6 percent per year of the projected nonhedgeable risk capital.

## Table 1

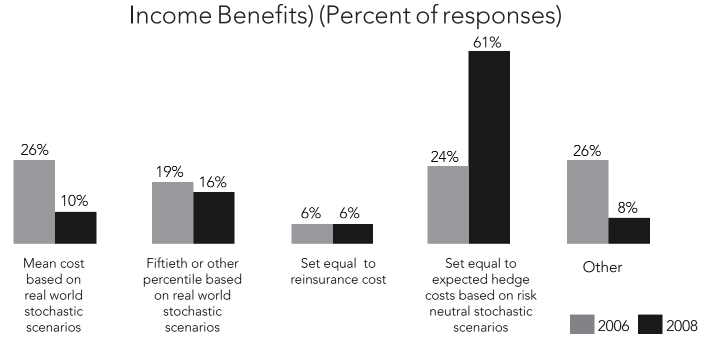
Typical Winners and Losers: Risk Based Pricing vs. Traditional Pricing

| Winners | Losers |
|---|---|
| Term Insurance | Payout Annuities |
| Group Life and Health/Employee Benefits | Fixed Annuities |
| | Variable Annuities/Segregated Funds |
| Universal Life/Variable Universal Life* | Universal Life/Variable Universal Life* |

* Depends on orientation of product (accumulation vs. protection), cost of insurance structure, investment options available and level of guarantees.

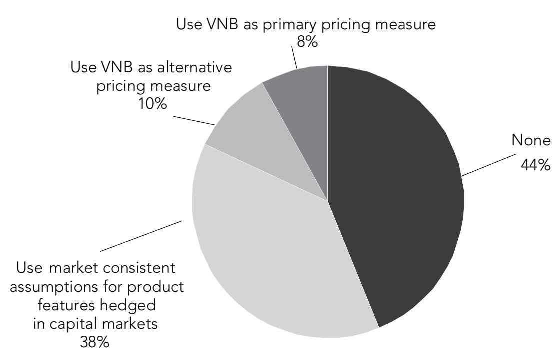
## Chart 1:
## Method Used to Determine Cost of Guarantees on VAs

(e.g., Guaranteed Minimum Death Benefits, Guaranteed Minimum Income Benefits) (Percent of responses)




Note: Companies selected multiple responses if they used different methods for different guarantees.

## Chart 2:
## Use of Risk Based Pricing Methodologies or Assumptions (Percent of responses)




Source: 2006 and 2008 Tillinghast Pricing Methodology Surveys (i.e., methodology used to price products in 2005 and 2007)

- Whether the product allows management discretion to mitigate adverse experience (e.g., ability to adjust future premiums, credited rates or policyholder dividends).

This makes sense. Everything else being equal (e.g., assuming the same product charges), a product (Product A) with more guarantees, more asset risk and without management levers to mitigate adverse experience ought to be considered more risky than a similar product (Product B) with opposite characteristics. The pricing metric used should show a less favorable result for Product A relative to Product B. This is the case under a market consistent framework.

Table 1 splits common products into two categories: those that show an increase in the profit margin when moving from a traditional approach to a market consistent approach and those that show a decrease in the profit margin.

While risk based pricing should be an important part of product design and pricing strategy, it should not necessarily be the only measure used. Other approaches, such as statutory IRR, for example, can provide useful insights into the potential future profitability of a product.

### Risk Based Pricing is not new is increasily being used and its use is expected to continue to increase

As shown in Chart 1, the approach used to set the cost of guarantees on variable annuity business has evolved from a deterministic real world approach (many years ago) to a stochastic real world approach (a few years ago) to a stochastic risk neutral approach (where we were in 2007 and where we are today).

So, risk based pricing is not new. As shown in Chart 2, some companies were using risk based pricing for products other than those hedged in the capital markets (i.e., variable annuity guarantees in most cases), but its use was not prevalent in the pricing of 2007 products. If this approach is considered best practice for setting costs on variable annuity guarantees, why wasn't it broadly used for other products?

While risk based pricing was not broadly used in 2007 for a wide range of products, this is gradually changing as market consistent techniques make their way into financial reporting, economic capital calculations, merger and acquisition and securitization transactions and asset-liability management. For example,

- US GAAP contains standards related to fair value measurement and options (FAS 157 and 159).
- The European Insurance CFO Forum Market Consistent Embedded Value Principles,[3] which were published in June 2008, require member companies to publish year-end 2011 embedded values and values of new business using market consistent techniques.
- Many companies, domestic and international, are using market consistent methodologies to determine economic capital (a la Solvency II).
- More and more merger and acquisition and securitization transactions are being valued using both traditional and market consistent techniques.
- Some companies are embracing market consistent techniques because they believe these methods provide useful insights into asset-liability management.

The above developments have motivated many companies to look at the profitability of their products under a market consistent framework. As a result, some of these companies have made or are in the process of making changes to their products and/or pricing. Other companies have embraced risk based pricing for its own sake. A few use it for incentive compensation to align compensation with risks undertaken.

IFRS Phase II, which is based on a fair value approach, could become required in 2014 in the United States and in 2013 in Canada. Consequently, the use of risk based pricing should continue to increase in North America.

## Those that act early can gain a competitive Advantage

Risk based pricing could be used to develop strategic options. Companies could target products where current product charges are greater than prices required by the market. Companies moving first would gain leverage by targeting profitable products. Eventually inefficiencies will be corrected as competitors catch up.

Companies could also use risk based pricing analyses to better understand the relative risks of their products. Depending on a company's risk appetite, measures could then be taken to de-risk certain products by increasing product charges or making changes to the product design. Product design changes could include decreasing interest rate guarantees, making variable annuity/segregated fund guarantees less rich, introducing market value adjustments upon surrender and changing premiums from a guaranteed basis to an adjustable basis.

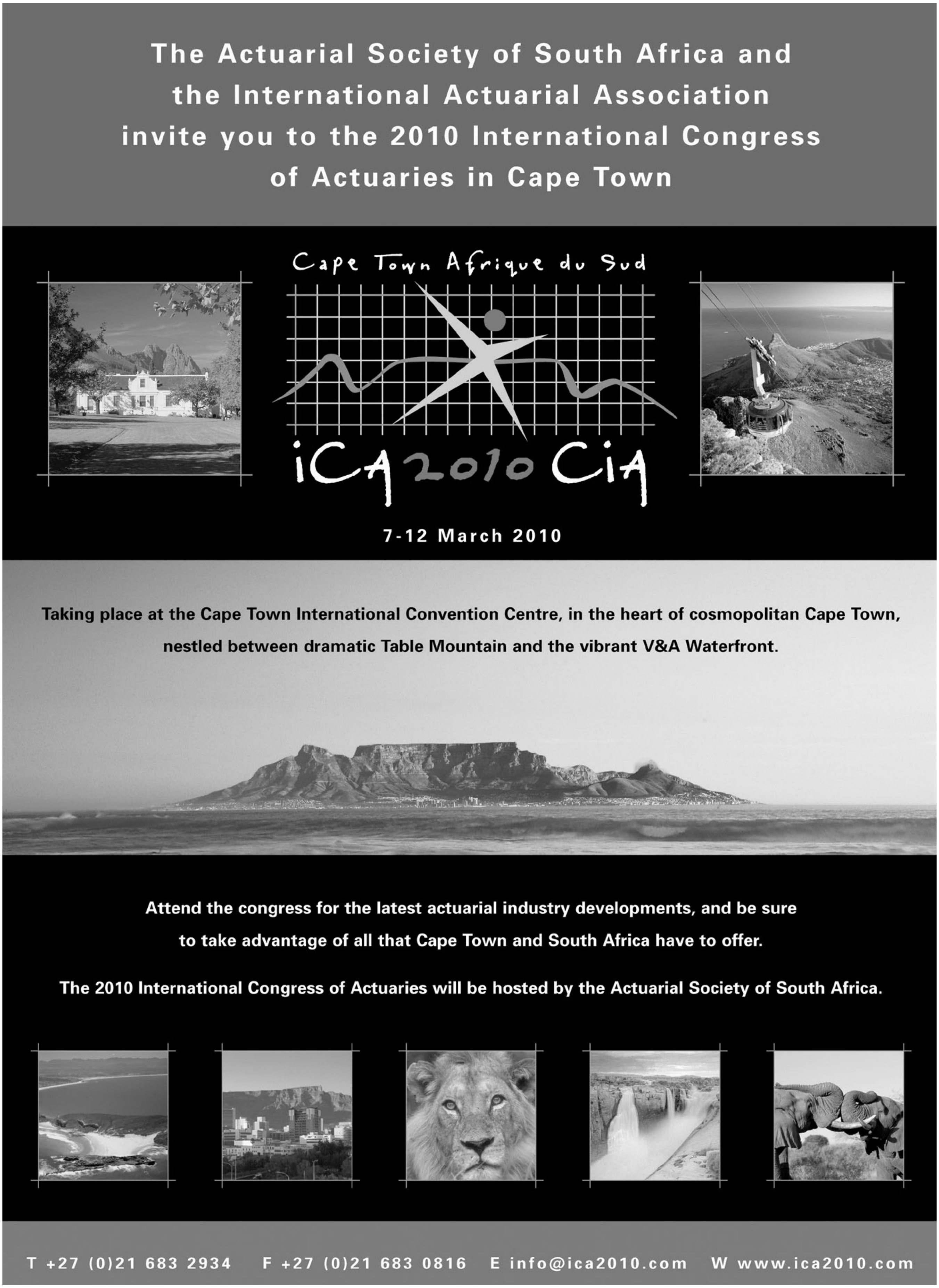
In addition, companies could use risk based pricing techniques to protect themselves against similar tactics used by competitors.

## Conclusion

Risk based pricing addresses some of the shortcomings of traditional pricing methods by providing a framework for understanding the tradeoffs between shareholder risks and rewards using a robust, transparent and objective economic methodology that is consistent across products. The use of risk based pricing has recently extended beyond variable annuity guarantees to a wide range of life, health and annuity products. More and more companies are looking at the profitability of their business under a market consistent framework motivated by FAS 157 and 159, MCEV Principles, economic capital calculations, insurance company transactions, asset-liability management and IFRS Phase II. Companies that are among the first to take action may benefit. ◻

*Dominique Lebel, FSA, MAAA, FCIA, is a senior consultant at Towers Perrin. He can be reached at Dominique.Lebel@towersperrin.com.*

[3] Copyright © Stichting CFO Forum Foundation 2008


The Actuarial Society of South Africa and
the International Actuarial Association
invite you to the 2010 International Congress
of Actuaries in Cape Town
Cape Town Afrique du Sud
iCA 2010 CiA
7-12 March 2010
Taking place at the Cape Town International Convention Centre, in the heart of cosmopolitan Cape Town,
nestled between dramatic Table Mountain and the vibrant V&A Waterfront.
Attend the congress for the latest actuarial industry developments, and be sure
to take advantage of all that Cape Town and South Africa have to offer.
The 2010 International Congress of Actuaries will be hosted by the Actuarial Society of South Africa.
T +27 (0)21 683 2934 F +27 (0)21 683 0816 E info@ica2010.com W www.ica2010.com

# Guaranteed Living Benefits: **Before the Meltdown**

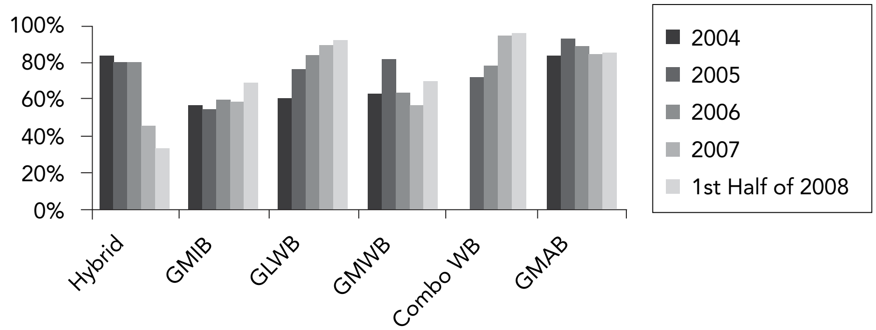
*by Sue (Sell) Saip*

The dominance of Guaranteed Living Benefits (GLBs) in the U. S. variable annuity (VA) market is well known. However, these features are still relatively new and trends regarding purchase rates and utilization rates are just beginning to evolve. Four primary types of GLBs are currently offered in the VA marketplace: Guaranteed Minimum Income Benefits (GMIB), Guaranteed Minimum Accumulation Benefits (GMAB), Guaranteed Minimum Withdrawal Benefits (GMWB) and Guaranteed Lifetime Withdrawal Benefits (GLWB). Some VA insurers offer hybrid GLB products that package together multiple GLBs, such as GMAB/GMIB or GMAB/GLWB. Others offer combination withdrawal benefits (GMWB/GLWB) that have the potential of providing both benefits to the policyholder. This design typically tracks both a GMWB and a GLWB feature for the policyholder and does not force the policyholder to elect either option on a stand-alone basis. Milliman, Inc. recently completed its fourth annual survey of leading variable annuity insurers to identify developing trends and experience in the VA GLB market. VA carriers that offer at least one type of GLB were invited to participate in the survey. The scope of the survey covered calendar years 2004 through 2007 and the first half of 2008. Note that responses were made during the last quarter of 2008, while the unsettled market conditions were beginning but had not yet reached their greatest stress. Twenty-one carriers participated in the survey (13 were top 20 carriers based on Morningstar, Inc.'s The VARDS Report) representing over 41 percent of total VA industry sales for the first half of 2008.

Based on the sales of survey participants, the average percent of such sales that offer any GLB has increased from 87 percent in 2004 to 96 percent during the first six months of 2008.

Sales information was reported by GLB type with averages of participants' responses shown in the chart on the right (top). The hybrid results are for the most popular design offered (GMAB with GLWB or GMWB). Other hybrid designs are offered by one company each. Note that the totals do not add up to 100 percent since multiple GLBs may be offered on the same product.

**Percentage of Total VA Sales that offer a GLB**




GLB election (purchase) rates were also reported by survey participants. Average election rates by GLB type are as follows:

| GLB Type Elected | Average Election Rate as a % of Total Sales of VAs that Offer the GLB | | | | |
|---|---|---|---|---|---|
| | Calendar Year 2004 | Calendar Year 2005 | Calendar Year 2006 | Calendar Year 2007 | YTD 6/30/08 |
| GMAB with GMWB or GLWB | 57.9% | 62.7% | 63.0% | 36.9% | 27.5% |
| GMIB | 49.0% | 42.1% | 36.0% | 28.4% | 24.9% |
| GLWB | 50.9% | 21.3% | 37.6% | 46.9% | 56.6% |
| GMWB | 25.0% | 18.5% | 23.4% | 19.4% | 14.4% |
| Combo GMWB/GLWB | | 58.3% | 51.0% | 40.9% | 37.0% |
| GMAB | 20.7% | 15.8% | 12.1% | 10.8% | 10.4% |

The distribution of sales by GLB type for survey participants was reported for calendar year 2007 and the first half of 2008. Since the introduction of GLWBs, there has been a shifting toward such sales and this trend continues as shown in the figures in the chart on page 10 (top).

CONTINUED ON **PAGE 10**

| GLB Type | Average Distribution of GLB Sales | |
|---|---|---|
| | Calendar Year 2007 | YTD 6/30/08 |
| Hybrid GLB | 9.2% | 4.9% |
| GMIB | 9.5% | 7.3% |
| GLWB | 41.9% | 63.9% |
| GMWB | 4.8% | 2.4% |
| Combo GMWB/GLWB | 28.9% | 16.6% |
| GMAB | 5.7% | 4.9% |
| Total | 100% | 100% |

| GLB Type | VA Customers that Purchase the GLB | VA Customers that do not Purchase the GLB |
|---|---|---|
| Hybrid GLB | 9.2% | 4.9% |
| GMIB | 9.5% | 7.3% |
| GLWB | 41.9% | 63.9% |
| GMWB | 4.8% | 2.4% |
| Combo GMWB/GLWB | 28.9% | 16.6% |
| GMAB | 5.7% | 4.9% |
| Total | 100% | 100% |

There is a notion that customers that purchase a GLB pay higher premiums than customers that do not purchase a GLB. The figures in the chart on the left (bottom) indicate that this appears to be true, on average, based on survey responses for guaranteed withdrawal benefits, however, these figures are greatly influenced by one insurer. The general relationship is not true for those that do and those that do not purchase GMIBs or GMABs.

Other statistics gathered in the latest survey looked at the utilization of the withdrawal benefit feature. Utilization of this feature refers to partial withdrawals being taken on policies with a withdrawal benefit. Utilization of withdrawal benefits were reported by withdrawal eligibility, by the percent of the withdrawal allowance used, and by the withdrawal timing. Withdrawals taken during the first six months of 2008 were broken down by contracts that were not yet eligible (e.g., minimum age requirement not met), contracts that include an incentive to delay the withdrawal (e.g., roll-up rates), and contracts that do not include an incentive to delay the withdrawal. Survey participants also reported the percentage of the withdrawal allowance that is used. For example, if the withdrawal allowance is 5 percent and a 4 percent withdrawal is taken, then this percentage would be 4 percent/5 percent which equals 80 percent. In addition, the timing of withdrawal rates was also reported. (See chart on the right, top)

Experience is gradually evolving regarding GMIB utilization rates. Utilization refers to the percentage of in force VA policies with GMIBs past the waiting period where a GMIB was exercised. Survey participants reported the percentage of in force GMIB business beyond the waiting period, the percentage of such policies where the GMIB was in-the-money, and the percentage of such policies that began income payments in the following calendar period. The chart on the right (bottom) summarizes the participants' responses.

Responses to the GLB survey were submitted during a time when GLB features continued to get richer and richer. The financial meltdown resulted in less generous benefits, higher charges, more restrictions, and less availability of some benefits. It may be some time before the GLB glory days return. ◻

| Utilization by: | Average Response - Withdrawals Taken during the First Six Months of 2008 | | | |
|---|---|---|---|---|
| | Hybrid Involving a WB | GLWB | GMWB | Combo GLWB/GMWB |
| Withdrawal Eligibility | | | | |
| Not yet eligible | 1.4% | 0.3% | 0.9% | 0.7% |
| Eligible – incentive to delay | 2.6% | 1.1% | 3.9% | 5.5% |
| Eligible – no delay incentive | 2.0% | 1.2% | 6.6% | 3.0% |
| | | | | |
| % of Withdrawal Allowance Used | 70.7% | 68.3% | 79.9% | 82.6% |
| | | | | |
| Withdrawal Timing | | | | |
| Withdrawals not started | 78.5% | 66.4% | 65.3% | 81.7% |
| 0 – 12 months after eligible | 23.4% | 31.0% | 16.4% | 14.7% |
| 13 – 36 months after eligible | 5.8% | 5.2% | 6.0% | 4.5% |
| > 36 months after eligible | 3.1% | 0.9% | 2.1% | 0.8% |

| 2004 | 2005 | 2006 | 2007 | YTD 6/30/08 |
|---|---|---|---|---|
| Average % of Inforce GMIB Policies Beyond the Waiting Period | | | | |
| 0% | 3.7% | 18.5% | 23.1% | 21.7% |
| Average % of Inforce GMIB Policies Beyond the Waiting Period where the GMIB was ITM | | | | |
| N/A | 71.5% | 64.2% | 71.6% | 65.3% |
| Average % of Inforce GMIB Policies Beyond the Waiting Period that Began Income Payments in the Following Calendar Period | | | | |
| N/A | 4.4% | 5.9% | 5.4% | 1.8% |

*Sue (Sell) Saip, FSA, MAAA, is a consulting actuary with Milliman Inc. She can be reached at sue.saip@milliman.com.*

# Modernizing the **Nonforfeiture Laws for Individual Life Products**

by David S. Lee

David S. Lee, FSA, MAAA, is a consulting actuary with Actuarial Resources Corporation. He can be contacted at actuarydl@aol.com.

It is time for the industry, regulators and consumer groups to rethink the purpose, the structure and the need for the nonforfeiture laws. These laws were first enacted approximately 60 years ago, before the computer age. They have served the industry well, but they now appear to be outdated and obsolete. An American Academy of Actuaries (AAA) Work Group is currently studying the possibility of revising the Standard Nonforfeiture Law to be consistent with the current realities of the life insurance marketplace. Hopefully, this article will be useful to those involved in this exercise.

In his Sept./Oct. 2003 article in *Contingencies* magazine, Jay Jaffe described several possible revisions to the law, including the possibility of outright repeal. In this article, I build upon some of Jay's suggestions by discussing the possibility of modifying or even eliminating life insurance cash value and nonforfeiture value legal requirements. In this context cash values include cash surrender values as well as the accompanying nonforfeiture options (extended term insurance, reduced paid-up insurance, etc.).

The remainder of this article discusses the following:

1. The primary reasons that the nonforfeiture laws exist, including comments on some of the problems associated with the laws;
2. A detailed case study comparison of traditional whole life to a universal life product with lifetime secondary guarantees (SGUL). This case study demonstrates that current laws permit widely varying minimum cash value requirements, depending on the underlying product chassis, for the same product. It is my opinion that this inconsistency is unacceptable; and
3. Recommendations and conclusions with suggested changes in the nonforfeiture laws that might be considered by the industry, regulators and consumer groups, including the possibility of eliminating the laws entirely.

## Why Does the Industry Have a Standard Nonforfeiture Law?

The need for nonforfeiture values, including cash values, is best described using a whole life policy as an example. Level premiums are paid for the life of the insured, and the insurance remains in force for life as long as the premiums are paid. Nonforfeiture values emerge because of the combination of level premiums and a mortality curve that increases with advancing age. In the early policy years a portion of the level premiums must be set aside to cover future (higher) mortality costs. The cash value represents a payment to the surrendering policyholder of a portion of these monies that have been set aside to fund, with future premiums, future benefits. A primary purpose of the Standard Nonforfeiture Law, and other similar laws is to mandate minimum nonforfeiture values that maintain equity between those policyholders who surrender and those policyholders who keep their insurance in force.

The Standard Nonforfeiture Laws, Universal Life Model Nonforfeiture Regulations and other similar laws and regulations are intended to require the appropriate minimum cash values for various life insurance products. Both the industry and state regulators have historically been very active in enforcing the minimum nonforfeiture requirements.

## What Are the Issues Associated with the Various Nonforfeiture Laws?

Some of the current issues associated with the nonforfeiture laws are discussed below.

- **The minimum cash value requirements are not consistent for various products.** One example of such an inconsistency is the SGUL and traditional whole life requirements. As discussed above, I believe the minimum cash value requirements should be identical for these products.

- **The expense allowance in the Standard Nonforfeiture Law is not closely related to typical acquisition costs.** Also, acquisition expenses can vary considerably based on the type of underwriting a company performs. The expense allowance does not recognize this variable.

- **The exemption allowed for group products in the Standard Nonforfeiture Law is not appropriate.** This is particularly true since many group products more closely resemble individual products than true group products. A traditional whole life product filed on a group basis can, in certain cases, avoid cash values because of the group exemption in the Standard Nonforfeiture Laws.

- **The nonforfeiture laws as currently constructed constrain product design and artificially increase premium rates in certain situations.** One example of this is the design of certain term insurance programs. The case study discussed below provides a second example.

The sections that follow include a detailed description and analysis of the SGUL and traditional whole life nonforfeiture inconsistencies.

## What is Secondary Guarantee Universal Life?

SGUL features typical universal life account value accumulations, current and guaranteed credited interest rates, cost of insurance charges, surrender charges, etc. Its distinguishing feature from other universal life products is that the death benefit is guaranteed for the lifetime of the insured, provided that certain minimum premium requirements are met. The death benefits remain in place even if the current and guaranteed account values go to zero.

So, what is SGUL? To address this question, it makes sense to avoid the typical universal life jargon about shadow funds, guarantee maturity premiums and the like, and simply look at the product performance. When viewed in this manner, the answer is that the product provides a death benefit for the lifetime of the insured as long as the policy premiums are paid. One would describe a traditional whole life policy in exactly the same manner. In other words, the SGUL product is whole life, yet SGUL typically has little or no guaranteed cash values. The cash values are much lower than the corresponding values that are required by the Standard Nonforfeiture Law for traditional whole life products.

The industry has engineered a whole life product having very small cash values, particularly on a guaranteed basis that complies with the universal life nonforfeiture regulations. As discussed below, I like this product from the consumer's standpoint (as long as the consumer does not intend to lapse the coverage). The product is very inexpensive in comparison to traditional whole life policies primarily because the premiums do not need to fund large cash value payments to surrendering policyholders.

## Sample Illustration

The following represents a typical SGUL illustration. The numbers are representative, but they do not duplicate an illustration of any particular carrier. They represent a combination of several companies' illustrations. The death benefit is $1 million and the insured is a 45-year-old, preferred, male nonsmoker.

### Sample Illustration<br>$1 Million Death Benefit<br>Age 45 Preferred Male Nonsmoker

| Policy Year | Premium | Death Benefit | Cash Surrender Value Current Basis | Cash Surrender Value Guaranteed Basis |
|---|---|---|---|---|
| 1 | $7,500 | $1,000,000 | $0 | $0 |
| 2 | $7,500 | $1,000,000 | $0 | $0 |
| 3 | $7,500 | $1,000,000 | $0 | $0 |
| 4 | $7,500 | $1,000,000 | $0 | $0 |
| 5 | $7,500 | $1,000,000 | $0 | $0 |
| 6 | $7,500 | $1,000,000 | $3,000 | $0 |
| 7 | $7,500 | $1,000,000 | $7,000 | $0 |
| 8 | $7,500 | $1,000,000 | $12,000 | $0 |
| 9 | $7,500 | $1,000,000 | $20,000 | $0 |
| 10 | $7,500 | $1,000,000 | $30,000 | $2,000 |
| 11 | $7,500 | $1,000,000 | $42,000 | $8,000 |
| 12 | $7,500 | $1,000,000 | $55,000 | $10,000 |
| 13 | $7,500 | $1,000,000 | $68,000 | $4,000 |
| 14 | $7,500 | $1,000,000 | $82,000 | $0 |
| 15 | $7,500 | $1,000,000 | $93,000 | $0 |
| 16 | $7,500 | $1,000,000 | $103,000 | $0 |
| 17 | $7,500 | $1,000,000 | $112,000 | $0 |
| 18 | $7,500 | $1,000,000 | $120,000 | $0 |

CONTINUED ON **PAGE 14**

### Sample Illustration
### $1 Million Death Benefit
### Age 45 Preferred Male Nonsmoker

| Policy Year | Premium | Death Benefit | Cash Surrender Value Current Basis | Cash Surrender Value Guaranteed Basis |
|---|---|---|---|---|
| 19 | $7,500 | $1,000,000 | $122,000 | $0 |
| 20 | $7,500 | $1,000,000 | $116,000 | $0 |
| 25 | $7,500 | $1,000,000 | $60,000 | $0 |
| 30 | $7,500 | $1,000,000 | $0 | $0 |
| 35 | $7,500 | $1,000,000 | $0 | $0 |
| 40 | $7,500 | $1,000,000 | $0 | $0 |
| 45 | $7,500 | $1,000,000 | $0 | $0 |
| 50 | $7,500 | $1,000,000 | $0 | $0 |
| 55 | $7,500 | $1,000,000 | $0 | $0 |
| 60 | $7,500 | $1,000,000 | $0 | $0 |
| 65 | $7,500 | $1,000,000 | $0 | $0 |
| 70 | $7,500 | $1,000,000 | $0 | $0 |
| 75 | $7,500 | $1,000,000 | $0 | $0 |

It is important to note the following:

- On a guaranteed basis, the product generates almost no cash values.

- There are some cash values on a current basis, but the current cash values are zero in most durations. For this generic illustration, the current cash values never exceed 12 percent of the death benefit.

- Both the account values and cash values are zero in the later durations. However, the death benefit remains at $1,000,000 as long as the annual premiums are paid, even though there is no cash surrender value and the account value has run out.

- For comparison purposes, it should be noted that the minimum required cash values for traditional whole life products are positive in all policy years beginning in policy year three, and reach $1 million in duration 75.

- The above annual premium is much lower than the premium for a typical whole life. At issue age 45, a whole life premium of $7.50 per thousand is quite inexpensive, even for a preferred nonsmoker.

Companies can get away with such low cash values for SGUL by creating complicated engineering to satisfy the universal life nonforfeiture laws while holding almost no cash values on a guaranteed basis. Of course, that requires constructing a very complicated universal life product to obtain this cash value advantage. If one were to view the illustration without knowing the underlying product chassis, the logical conclusion would be that the product is some sort of whole life product with very limited or no cash values. If one reviews the guaranteed ledger, one can conclude that the product is very close to zero cash value whole life.

## Discussion—SGUL Versus Traditional Whole Life

As discussed above, the SGUL premiums are quite low relative to traditional whole life premiums, primarily because the premiums do not have to fund substantial cash value payments to surrendering policyholders. Therefore the product offers exceptionally good value to an insured planning to keep the policy until death. In other words, this is a great product for the right client.

However, the policy would typically not provide a fair value to a surrendering policyholder. As discussed previously, the cash values are much lower than those required by the nonforfeiture laws for whole life policies employing a traditional chassis.

What is the right level of cash values for SGUL? One can certainly argue that it is acceptable to have low, or zero, cash values because this enables the company to charge very competitive premiums. If customers are given a choice between low premiums and cash surrender values, I believe a large percentage of the customers would choose the lower premiums. (Actually, one can argue that many customers have already made that choice given the popularity of SGUL.)

If one continues the logic from the previous paragraph, why can't companies offer the same choice to traditional whole life policyholders? I believe a large percentage of those policyholders would also choose the lower premiums. However, we are not allowed to offer that choice on traditional whole life policies because the low premium, low cash value choice would violate the Standard Nonforfeiture Law.

Therefore, the Standard Nonforfeiture Laws are preventing our industry from designing a traditional whole life product having premium rates competitive with those available in a SGUL chassis. If we want such a product, we need to introduce all of the artificial complexity of universal life because that allows us to work with a more favorable interpretation of the nonforfeiture law.

In my opinion, it is unacceptable to have different nonforfeiture value requirements for SGUL and for traditional whole life products. Since SGUL is essentially a fancy whole life product, as discussed previously, why should the minimum nonforfeiture value requirements for whole life products be drastically different depending on the underlying product chassis? The current laws that permit this cash value structure are quite unfair to small insurance companies that may not be able to economically administer a SGUL product. Since SGUL is essentially whole life, the same choices discussed previously should be available for both SGUL and traditional whole life. If the regulators are comfortable with the fact that SGUL generates almost no guaranteed cash values, then the regulators should permit a similar traditional whole life design, perhaps with some corresponding disclosure. However, this can be accomplished only with a major revision or repeal of the Standard Nonforfeiture Law.

### How Much Lower Would Traditional Whole Life Premiums Be If the Products Did Not Have Cash Values?

I reviewed some traditional whole life pricing that I have recently completed, and my estimate is that at least 20 percent to 25 percent of the gross premiums are used to fund the cash values. In other words, if we were able to offer a whole life product with no cash values, we could lower the gross premiums by 25 percent.

> "In my opinion, it is unacceptable to have different nonforfeiture value requirements for SGUL and for traditional whole life products."

The question then becomes, "Is it worth sacrificing this equity between classes of policyholders to allow a whole life product to have little or no nonforfeiture values because such a design allows a 25 percent reduction in gross premiums?" I believe a large percentage of our customers would choose the lower premiums. For premium-driven sales, a zero cash value whole life product would allow more families to obtain the amount of coverage they need at the price they can afford. For those customers preferring higher premiums and cash values, companies could design such a product for them. Customers could be given a choice of products at various premium and cash value levels.

### Recommended Courses of Action

The first two bullet points below would require major changes to the current law. The remaining bullet points would allow the current structure of the laws to remain in place. My preference would be to implement the first bullet point, the outright repeal of the law.

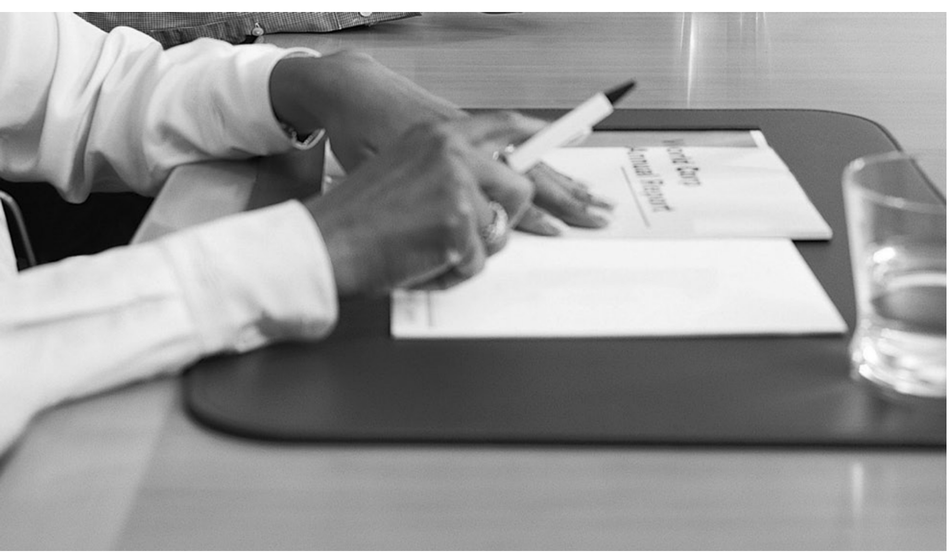
- One possibility would be an outright repeal of the nonforfeiture laws. The market would then determine to what extent and at what cost insureds might want cash value benefits. From a practical matter, we might still want the nonforfeiture laws to apply for small policies, such as $50,000 or less. It would be important to make sure that appropriate disclosure would accompany this alternative.

CONTINUED ON **PAGE 16**

- Another possibility could be to remove the current inconsistencies in treatment that exist between the various laws. A whole life product is a whole life product whether it is on a universal life chassis or an individual chassis. If it is possible to nearly eliminate cash values for whole life on a universal life chassis, then the same possibility should exist for traditional whole life. One can make the same argument about group whole life versus individual whole life. It no longer makes sense to allow group whole life to be exempt unless individual whole life is also exempt.

The remaining suggestions may be considered tweaks to the current law.

- It would make sense to increase the term insurance exemptions to higher ages and longer term periods. This would help lower the cost of term insurance. In most term insurance sales situations, cash values are not an important feature to the customer. Currently, companies wishing to take full advantage of the term cash value exemption need to prepare two filings for the same product. (One filing at the younger issue ages would take advantage of the cash value exemption while the second filing would include only the older issue ages, and contain cash values.)



- It would make sense to update the expense allowances, tying them to actual expenses. Another possibility would be to permit a company to tailor the expense allowance directly to its expenses.

As discussed previously, I prefer the more drastic of the approaches. If we were to eliminate the nonforfeiture requirements completely, we would be giving up some of the equity issues discussed above, but we would likely see a large number of very inexpensive products flood the markets. Customers who want products with cash values could purchase those products. Customers who did not care about cash values could purchase the less expensive products. In other words, inexpensive whole life products would not need to include account values, shadow funds, no-lapse premiums or secondary guarantees. The inexpensive products could be plain vanilla whole life.

## Conclusion

In my opinion it is time for insurance regulators and industry professionals to recognize the need for a major change in the nonforfeiture laws. I am by no means an advocate of total deregulation, but I do believe we need to use a new, different approach to adopt legislation that is more appropriate for the 21st century. I am hopeful that the AAA Work Group that is currently addressing changes to the laws will consider some of the ideas discussed above.

# 2009 Annual Meeting Sessions Sponsored by the **Product Development Section**

by Cathy Bierschbach

Planning for the annual meeting is going full steam. As I am writing this article, various diligent volunteers are putting the finishing touches on their session descriptions. The product development section will be putting on some great sessions and most likely partnering with other sections for joint sessions. The SOA will be monitoring the pulse of the industry to find some last minute hot topic sessions to add to the lineup (some of today's hot topics will hopefully be yesterday's news by the time October gets here).

Although I am tempted to keep this article vague so that I can reuse it next year, it would be appropriate that I share with you what I do know for sure about this year's meeting (and I always like to be appropriate):

- What: 2009 Society of Actuaries Annual Meeting
- When: October 25-28, 2009
- Where: Boston Marriott Copley Place and Westin Hotel Copley Place Boston, Mass.
- Sessions: Thrilling and educational

While I can't guarantee the exact sessions since the scheduling has not been finalized, I am fairly certain that:

- We will once again be sponsoring a delicious hot breakfast that will give you an opportunity to network with your colleagues.
- The Year in Review will once again be back. Rumor has it that the session is receiving a complete makeover including new panelists.
- There will be product-specific sessions.
- Stuff about this "interesting" economic situation that we are in now will be discussed.
- Smart actuaries will present twists on how we should price under evolving frameworks (we need to shake up the world every so often so we don't get bored).
- There will be discussions about people dying too soon and/or living too long (face it, as life actuaries we need to discuss mortality and nowadays the longevity threat).

All in all it will be an exciting time in Beantown. All the cool actuaries will be there getting their continuing education and mingling with their friends (and sometimes family). So mark your calendar and allocate some of that precious travel expense budget for the big event. ◻

*Cathy Bierschbach, FSA, MAAA, is vice president of Transamerica Insurance & Investments. She can be reached at cathy.bierschbach@transamerica.com.*

# Summary of **March 2009 NAIC/LHATF Meeting**

by Donna R. Claire

*Donna R. Claire, FSA, MAAA, is president of Claire Thinking, Inc. She can be reached at clairethinking@cs.com.*

The March 2008 NAIC meeting was held in sunny San Diego. As usual, much time was spent on principle-based approaches (PBA) to reserves and capital issues.

**Life Risk Based Capital:** Philip Barlow ran a very good, succinct, RBC meeting from 5 p.m. to 6 p.m. on Saturday. A major accomplishment was to expose the RBC C-3 Phase III report. This would apply a PBA to life insurance capital, including in-force. There are some alternative methods mentioned, which would allow many companies to effectively opt to continue the current factor-based approach, but it will also allow other companies to begin using a more comprehensive PBA if they desire. Because of the options, I do not see a reason this should not be adopted for 2009 year-end. This document is being exposed and the RBC group will make a decision on it by the June NAIC meeting.

**Life and Health Actuarial Task Force:** The first action of LHATF was to welcome back the chair, Larry Bruning, who has had some health issues. He's feeling much better, and thanked everyone for their good wishes.

## Updates on LHATF projects:

**1. SVL2:** The current exposure of changes to the Standard Valuation Law (SVL) was left exposed, to ensure that no other wording tweaks were needed. It is expected that this could be voted on via an interim conference call, and sent up to their NAIC parent committee shortly.

**2. Valuation Manual:** Much of the LHATF meeting was spent reviewing the work of the LHATF subgroups working on various sections of the Valuation Manual:

**a. VM-00, 01:** Mike Boerner heads the LHATF team on this part of the Manual (as well as heading the Academy team on the Valuation Manual in general). These sections of the Valuation Law on Process and Coordination are exposed. There is some additional tweaking of wording expected. In addition, there is an Academy project, headed by Alice Fontaine, to develop a pros and cons document on various scope alternatives (e.g., should PBA apply immediately to all life products, only to term and UL with secondary guarantees, should there be phase-ins?). Alice gave a report at this LHATF meeting, and expects to have a more detailed report in the next few weeks.

**b. VM-20:** A large portion of the LHATF meeting was spent on VM-20, which gives the requirements for life insurance. Pete Weber heads this effort for LHATF, and has done a masterful job getting through the document and virtually all the proposed amendments. There are a few open issues, and much of LHATF's time at this meeting was taken up on these. Pam Hutchins presented an Academy recommendation to allow scenario reduction techniques when stochastic scenarios are required. One big open issue was how to come up with a net asset earned rate; Gary Falde and Alan Rothenstein head an Academy group that has developed a potential methodology that LHATF could use to set default rates and effectively limit the asset rates assumed in modeling for reserves. This will be discussed further on a conference call, but it looks like a very workable solution. John Bruins gave an ACLI presentation on a net premium approach for life reserves, which is proposed because of tax reserves considerations. This proposal is not in final form; this is likely the big remaining open issue at this time.

**c. VM-20, Reinsurance:** Sheldon Summers heads the LHATF subgroup on reinsurance, as well as heading the Academy group on the same subject. One open issue is how reinsurance should be handled under PBR: if the ceding company has to calculate both a reserve gross of reinsurance and a reserve net of reinsurance, how will it be done, considering that the reinsurer and ceding company may not be valuing the business in the same manner? A conference call is being scheduled to finalize this issue. A second issue is whether credit can be taken in PBR reserves for reinsurance treaties that do not pass-on all the risk, e.g., one that reinsures just the secondary guarantee on a UL with secondary guarantee. This issue would likely involve changing the reinsurance regulation—VM-20 would not need to be held up pending resolution on this.

**d. VM-21:** This section would simply bring in the Variable Annuity CARVM Actuarial Guideline, which goes into effect at year-end 2009. The guideline is obviously already written, so this would simply be a matter of making sure it is in the right format.

**e. VM-25, 26:** These are the health sections. Julia Phillips headed this group. At this time, there are no changes expected to the health reserving requirements. These sections codify the current plans, and are complete.

**f. VM-30, 31:** Katie Campbell heads this effort on PBR reporting and review. There is a bit of wording being looked at regarding the actuarial opinion, but otherwise, VM-30 looks like a wrap. VM-31 has been tracking the requirements of VM-20, but also looks to be in reasonable shape.

**g. VM-50, 51:** Fred Andersen is heading this effort on PBR Experience Reporting. He reported that New York is getting close to issuing an RFP for reporting mortality experience; this reporting is specifically needed to satisfy a condition of using the current interim preferred mortality tables on the 2001 CSO. This experience can be used to see whether any additional changes are needed to the VM sections. There will probably be some sort of exemption for smaller blocks of business.

In summary, the Valuation Manual is quite close to being a reasonable draft that can be passed on to the parent committees of LHATF. It is not, nor is it ever expected to be, final (i.e., new product lines are expected to be added, and other changes to rules are expected to be made as new facts become available over the years).

**3. Mortality:** There were several mortality projects discussed at LHATF:

**a. Preferred Mortality—new CSO?:** Tim Harris gave an update on the joint SOA/AAA project on preferred mortality. The mortality since the 2001 CSO has been issued has noticeably improved. There was an open question as to whether there should be a 2008 CSO. Tim Harris' group did some analysis, which showed that, if a company was using the 2001 CSO tables without the interim solution splits, there would be a noticeable reduction in term reserves, with a lesser reduction in whole life reserves. However, if a company were using the interim tables, the differences in reserves were much smaller. LHATF is going to conclude this matter on a conference call. They have requested that the AAA/SOA group do additional analysis comparing the basic mortality differences between the 2001 and 2008 tables.

**b. Underwriting Criteria Score:** For the PBA project, it is still anticipated that companies without credible experience would need to rely on the Valuation Basic Tables as developed by the SOA, using underwriting criteria scores to determine which tables to use. It was announced that the debit/credit methodology to figure out the underwriting criteria score is in its final stages of review, and should be on the SOA Web site.

CONTINUED ON **PAGE 20**

**c. Simplified Issue/Guaranteed Issue Mortality:** LHATF has asked the SOA/AAA to determine a reasonable mortality basis for simplified issue and guaranteed issue plans. The concern is that the 2001 CSO may not be sufficient. The SOA/AAA group will look at this, with Mary Bahna-Nolan leading this effort.

**d. Individual Annuity Mortality:** The SOA is also putting final touches on the report on individual annuity mortality. At LHATF's request, the SOA/AAA will be developing new Valuation Tables for Individual Annuities. The Individual Annuity mortality has shown marked improvement, particularly for the larger annuity payout amounts. Mary Bahna-Nolan will also be leading this project.

**4. Capital and Surplus Relief:** LHATF has been charged with fast-tracking the Capital and Surplus Relief items that were proposed last year due to the economic turmoil, but ultimately not enacted because the industry did not prove that there was a dire emergency. Therefore, LHATF exposed the three documents that they had agreed to on this matter: Known as proposal 1a (the proposal to allow the 2001 Preferred tables to be used for all 2001 business, even if issued prior to 1/1/2007); 1c (which clarified that the preferred smoker/non-smoker tables can be used in determining segments); and 2 (which allows X factors for deficiency reserves to go below 20 percent, and that the X factors can decrease by duration).

**5. Standard Nonforfeiture Law:** Work continues on modernizing the Standard Nonforfeiture Law. John MacBain is leading this effort. In addition, there was a discussion on whether changes that are proposed to the current nonforfeiture law to accommodate PBR need to be revised to ensure proper tax treatment. The ACLI is looking at what wording changes they recommend.

In summary, PBA has made significant progress over the past couple of years. It seems quite likely that PBA will expand into the RBC arena soon, and that PBA reserves, at least for some products, will be adopted by the NAIC this year, to be brought before legislatures in the next couple of years. □

# Whither the Definition of "Cash Surrender Value"—The IRS Issues More Waiver Rulings Discussing the Meaning of Section 7702(f)(2)(A)

by John T. Adney and Alison L. Reynolds

*Editors' Note: Reprint courtesy of the Taxation Section. This article first appeared in the May 2009 issue of* TAXING TIMES.

The September 2006 issue of *TAXING TIMES* featured an article entitled *Private Rulings Regarding "Cash Surrender Value" Under Section* 7702 written by Craig R. Springfield and Brian G. King. That article discussed two private letter rulings[1] issued by the Internal Revenue Service ("IRS") in 2005 (collectively, the "2005 Rulings") that waived errors relating to the definition of "cash surrender value" under section 7702(f)(2)(A).[2] In the 2005 Rulings, the IRS concluded that certain amounts made available on the surrender of life insurance contracts, called "remittances" in the rulings, represented "cash surrender value" within the meaning of section 7702(f)(2)(A) even though they were not part of the surrender value identified as such in the contracts. In both cases, the IRS waived failures to comply with the requirements of section 7702 because the insurers' errors in interpreting the cash surrender value definition were considered reasonable under section 7702(f)(8). During 2008, the IRS issued two additional waiver rulings that reached a similar conclusion, but in doing so shed more light on the facts involved and addressed the tax treatment of the corrective action itself. The discussion that follows begins with a review of the definition of "cash surrender value" in section 7702(f)(2)(A) and in the regulations proposed under that provision but never finalized. The discussion then recaps the 2005 Rulings, describes the recently issued letter rulings, and concludes with some ruminations about the consequences of the approach being taken by the IRS.

## The Statute and the Proposed Regulations

Section 7702 constrains the investment orientation of life insurance contracts by requiring, in different ways, that the "cash surrender value" of a given contract have a minimum amount of death benefit associated with it. Much of the complexity of the statute arises from the legislative attempt to define what that minimum amount is. For this purpose, section 7702(f)(2)(A) provides that a contract's cash surrender value is its "cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends." However, nothing in section 7702 or elsewhere in the Code undertakes to define the more fundamental term, "cash value." When section 7702 was enacted in 1984, the meaning of this term was not in question. After all, nonforfeiture values available on surrender of a contract for cash had been defined in state law for over a century, and to find a contract's cash value, all that one had to do was to read the contract's terms. Just two years prior, the same, simple reference to "cash value" was used in the revision of section 72 to address the treatment of withdrawals from nonqualified deferred annuities, and there again, no elaboration of the term's meaning was provided or requested.

The legislative history of section 7702 furnished little additional guidance on the meaning of "cash value," although what it added as a gloss on the statute both spawned debate and laid the foundation for the 2005 and 2008 private letter rulings. According to the congressional committee reports on the 1984 law, cash surrender value for section 7702 purposes is "the cash value of any contract (*i.e.,* any amount to which the policyholder is entitled upon surrender and against which the policyholder can borrow) determined without regard to any surrender charge, policy loan, or a reasonable termination dividend."[3] Further, the committee reports' reference to "and against which the policyholder can borrow" was used in the very same legislative history to justify excluding return-of-premium benefits under credit life insurance contracts from being treated as cash values.[4] However, as the ink was drying on these reports, there apparently was some rethinking on the part of the Joint Committee on Taxation staff about what the talismanic "and" might connote. Perhaps out of some unarticulated concern, the Joint Committee staff's Blue Book on the 1984 law, published in January of 1985, modified the committee reports' statement after the fact by rephrasing it as: "and, generally, against which the policyholder can borrow."[5]

As of this writing, nearly 25 years after the enactment of section 7702, no formal regulatory guidance—whether in the form of regulations or revenue rulings—has been issued on the meaning of either "cash surrender value"

CONTINUED ON PAGE 22

John T. Adney is a partner with the law firm Davis & Harman LLP. He can be reached at jtadney@davis-harman.com.

Alison L. Reynolds is an associate with the law firm Davis & Harman LLP. He can be reached at areynolds@davis-harman.com.

or "cash value" as used in section 7702 (or section 72, for that matter). The IRS did try to issue guidance, however. In particular, when it proposed regulations in 1992 primarily to deal with the treatment of terminal illness and other life insurance accelerated death benefits, the IRS addressed those benefits in the context of a fairly elaborate structure defining "cash value" for purposes of section 7702. Under the regulations as proposed, this cash value for any life insurance contract was said to equal the greater of (1) the maximum amount payable under the contract (determined without regard to any surrender charge or policy loan), "or" (2) the maximum amount that the policyholder could borrow under the contract, all subject to specified exceptions (such as death benefits, accelerated benefits for the terminally ill, and certain termination dividends).[6] Notably, the proposed definition converted the "and" in "and against which the policyholder can borrow" to a decidedly different term, *i.e.,* "or." For this and other reasons, the life insurance industry protested against the broad sweep of the proposal, and less than four years later, the enactment of sections 101(g) and 7702B rendered the principal motivation behind the proposed regulations obsolete.

With the effort to define cash value stewing in controversy and much else to do, the IRS chose to let the proposed regulations lie fallow. Moreover, in Notice 93-37[7] the IRS announced that the effective date of the proposed regulations would be no earlier than the date of their publication as final regulations in the Federal Register. The Notice also said that it was anticipated that insurers generally would be allowed a period of time after the publication of the final regulations to bring their policy forms into compliance with any new rules. This publication has not happened, and so, as a legal construct, the proposed regulations are technically inoperative.

The death of these proposed regulations, however, has likely been exaggerated. As discussed in the previous *TAXING TIMES* article on the subject, even though the cash value definition in the proposed regulations differs materially from the definition in the legislative history, the thinking of the IRS clearly is guided by the former. At one level, this is not surprising, for it is inviting to rely on the all-encompassing and well-articulated, if broken, standard like the one proposed. At the same time, in light of the criticisms leveled against the approach taken in the proposed regulations, let alone the announcement in Notice 93-37, reliance on that standard is questionable policy. Were the IRS to proceed with revising the proposed definition of cash value, to take account of the criticisms and conform the definition to the congressional intent, and then finalizing the new rules with a prospective effective date, this would be a useful step (more on this later). At minimum, it probably would avoid the need of life insurers and the IRS to continue the saga of the letters rulings next discussed.

## The 2005 Rulings

As described in the *TAXING TIMES* article in 2006, the contracts involved in the 2005 Rulings were fixed and variable, flexible premium contracts designed to comply with the cash value accumulation test of section 7702(a) and (b) (the "CVA Test") or, in some cases, with the guideline premium limitation and cash value corridor tests of section 7702(c) and (d) (the "GP Test"). In both rulings, the contracts provided for a policy value that was available on surrender, and also provided for certain additional amounts—labeled the "remittances" in the rulings—that would be payable on surrender in the early durations of the contracts. Significantly, the contract owners could not borrow under their contracts against these remittances, and since these amounts were not part of the policy value, the insurers involved in the rulings understandably did not reflect them in the "cash surrender value" that was used for CVA Test or GP Test purposes. Rather, only the contracts' policy value was utilized for those purposes, thereby setting up the problem that was taken to the IRS for resolution.

In the 2005 Rulings, the IRS first considered whether the remittances were properly excluded from the cash surrender value of the contracts for section 7702 purposes, and concluded that they were not. For the construction of the cash surrender value definition in section 7702(f)(2)(A), the IRS looked to a number of sources, including a leading insurance textbook that defined a contract's cash surrender value as "the amount made available contractually, to a withdrawing policyholder who is terminating his or her protection"[8] and another one that defined it as "the amount available to the policyholder upon the surrender of the life insurance contract."[9] The IRS also looked to the proposed regulations under section 7702(f)(2)(A), which (as described earlier) swept into the cash surrender value all amounts payable on surrender unless excluded by a specific exception. Applying that standard as well as the teaching of the insurance texts, the agency determined that the remittances needed to be included in the contract's cash surrender value for section 7702 purposes.

The foregoing conclusion meant, of course, that the contracts did not contain the proper formula for compliance with the requirements of section 7702. Recognizing this, the IRS next considered whether the error in not treating the remittances as part of the contracts' cash surrender value was a reasonable one within the meaning of the waiver authority granted in section 7702(f)(8). The ruling letters noted that the language of the legislative history defining the section 7702 cash surrender value was not "identical" to that of the proposed regulations—a nod to the very different wording of the two when it came to the effect of the contract owner's borrowing rights—and that the proposed regulations had not been finalized. Citing to these facts and to the prospectivity promised in the 1993 Notice, the IRS held the error to be reasonable and used its authority under section 7702(f)(8) to waive the failures.

## New Private Letter Rulings

After a brief hiatus in waiver ruling activity on this topic,[10] more of the same followed in 2008. In PLR 200841034 (March 28, 2008) (the "2008 Ruling"), the "remittances" again made an appearance as a life insurance company requested a waiver for its failure to include them in its contracts' cash surrender value for purposes of the CVA Test. This time, however, the ruling letter did not first stop to consider whether, on the merits, the remittance amount should be included in or excluded from the cash surrender value. Instead, the IRS focused on the insurer's admission of error and request for a waiver under section 7702(f)(8).

Under the facts of the 2008 Ruling, the insurer issued flexible premium, variable life insurance contracts that were designed to meet the requirements of the CVA Test "by multiplying the Contract's 'Cash Value' by a percentage identified in the Contract," this percentage being "intended to equal the amount required to maintain the Contract's compliance at all times with the CVA test." Not included in this "Cash Value," however, was an additional amount—the remittance—that the insurer guaranteed to pay if a contract were fully surrendered within its first three years. This amount, according to the ruling letter, essentially represented a portion of the premium loads assessed in the year of surrender. The ruling letter noted that the insurer had interpreted the legislative history of section 7702 as providing that the "cash surrender value" is an amount that the owner can both receive on surrender and borrow under the contract, and that as a result of this interpretation, the remittance amount, which was not subject to borrowing, was not included in the section 7702 cash surrender value under the contracts as drafted. Further, because the remittances were not part of the contract's cash value, they did not grow with interest or earnings, nor did they decrease the net amount at risk, and hence the cost of insurance charges, under the contracts.

The 2008 Ruling then pointed out, still in the "Facts" portion of the ruling letter, that the omission of the remittances from the contract's cash surrender value resulted in the contracts' failure to comply with the CVA Test. This statement of the conclusion is quite interesting, arriving as it does after the recording of facts showing that the remittances did not function like a cash value and before any analysis in the ruling letter as to why they were, nonetheless, part of the cash surrender value under section 7702. While perhaps this approach can be justified on the grounds that the taxpayer admitted error in the first instance, it may be even more revealing of the IRS's (and the taxpayer's) view of the situation. By 2008, it was clear to the IRS and to a number of life insurers that remittance-like items were part of the section 7702 cash surrender value, whether or not they could be borrowed against, whether or not the proposed regulations had been finalized, and regardless of the terms of Notice 93-37. For that matter, such items were accepted as section 7702 cash value even though they apparently have

CONTINUED ON PAGE 24

not been so treated under state nonforfeiture law.[11] The analysis in the 2008 Ruling, for its part, generally did no more than the 2005 Rulings: after reviewing the same authorities, including the proposed regulations, noting the discrepancy in the wording on borrowing between the legislative history and the proposed (but never finalized) regulations, and further noting that the 1993 Notice indicated that insurers would be allowed to bring their policy forms into compliance with any new rules, the IRS concluded that the failure to satisfy the requirements of the CVA Test should be waived because the taxpayer's error was reasonable.

Then, in a departure from the 2005 Rulings, the 2008 Ruling went into greater detail about the tax treatment of the correction of the error. As in the earlier rulings, the taxpayer corrected the CVA Test compliance error by amending the contracts—in this case, adding an endorsement to the contracts—so that the remittances were included in the contracts' cash value during the period that they could be paid on surrender. This endorsement, according to the 2008 Ruling, was made effective retroactively to the issue dates of the contracts involved. Since this entailed amending the contracts, it presented a question whether the correction resulted in a material change to the contracts, raising the specter of a deemed new issue date for the contracts under the tax law. To preclude this, and presumably relying on the retroactive effective date of the endorsements, the IRS specifically held that the addition of the endorsement to correct the CVA Test failures would not affect the contracts' "issue" or "entered into" dates and did not result in a change in benefits under the section 7702(f)(7) adjustment rule or a material change for section 7702A purposes. As a result, according to the ruling, the endorsement's addition would not affect the contracts' "grandfathered" status for purposes of sections 72, 101(j), 264, 7702, and 7702A, would not affect any testing periods under sections 264(d), 7702, or 7702A, and in general would not give rise to an exchange for tax purposes. This produced a sensible conclusion, for if the correction of compliance problems itself gave rise to a material change under the tax law, the result would be a cascading of troubles for insurers endeavoring to assure that their contracts meet the requirements of section 7702.

The other recent letter ruling, PLR 200901028 (September 29, 2008) (the "2009 Ruling"), mimicked the 2008 Ruling and its forebears in large part, but elaborated on why the additional amounts were being guaranteed by the insurer. In the 2009 Ruling, a life insurance company requested a section 7702(f)(8) waiver for certain contract endorsements that caused its contracts to fail the requirements of section 7702, and further asked for material change relief similar to that requested by the insurer in the 2008 Ruling.

The statement of facts in the 2009 Ruling was similar to that of the 2008 Ruling but provided more detail. According to the ruling, the insurer issued a variety of life insurance contracts to corporate policyholders. Some of these contracts were intended to comply with the CVA Test, and the rest were subjected to the GP Test. The problem arose when the insurer endorsed the contracts involved in the ruling with an amendment that guaranteed a cash surrender value for a specified period of time that was higher than that defined in the base contracts. The ruling recorded that the insurer did so in response to requests from corporate policyholders that this guarantee of a temporarily higher surrender value was necessary to enhance the early duration policy values, so that the contracts did not have a negative effect on the policyholders' profit and loss statements during the early policy years. Further, according to the ruling, the additional surrender benefit provided by the endorsements was "a function of a return of premiums paid and/or a reduction of the charges assessed as of the date of surrender," but it "may not be borrowed against."

The insurer represented to the IRS that due to the addition of the endorsements, the contracts failed the CVA Test by the terms of the contract, and failed the GP Test if they were in the cash value corridor of section 7702(a)(2)(B) and (d) during the period when the additional benefit was available. According to the 2009 Ruling, this failure was attributable to the insurer's erroneous assumption that the amount made available on surrender was not includible in the contracts' cash surrender value for section 7702 purposes, thereby rendering the death benefits provided under the contracts improperly low. The ruling noted, interestingly, that

CONTINUED ON PAGE 26

the insurer discovered it had committed this error after reading the 2005 Rulings. This may be the best evidence yet that in the world of insurance taxation, where published guidance is difficult to come by, both insurers and the IRS look to the body of private letter rulings to divine the mysteries of the Code. As tax professionals in and out of the government recognize, however, private rulings do not constitute precedent for a reason extending beyond the formal rule in section 6110(k)(3), *i.e.,* they do not receive the thorough review that published guidance does. Query, then, whether reliance on the teachings and conclusions of private letter rulings is an appropriate way to administer the tax law, particularly when they emanate from section 7702(f)(8) waiver requests, in which the taxpayers are conceding error. (But we digress.)

“The body of waiver rulings discussed here hint at, but do not directly address, a potentially much more significant subject. …”

In its analysis in the 2009 Ruling, the IRS reviewed the same authorities that were cited in the 2008 Ruling (and its predecessors). On the same reasoning as before, the IRS concluded that the additional cash value guaranteed on surrender for the temporary period should have been included as part of the contracts’ cash surrender value for section 7702 purposes, and so it agreed that the insurer’s admission of error was correct. Further, following its prior reasoning, the IRS agreed that the error was reasonable and the compliance failures therefore were waivable.

The correction discussion in the 2009 Ruling also followed the pattern of the 2008 Ruling, although with some new facts and an intriguing twist. The insurer proposed to correct its endorsed contracts either by replacing the current endorsements with new ones that complied with section 7702, or by replacing the entirety of the current contracts with new contracts and endorsements that were compliant with the statute. Further, where the new contracts or endorsements were “not in use or available”—presumably meaning not yet approved by the appropriate regulatory authorities—the insurer proposed to provide a “binding letter” to the affected policyholders promising to pay the higher death benefits resulting from the inclusion of the additional benefit as part of the cash surrender value. In connection with these steps, the insurer asked, and the IRS agreed, to hold that “[n]either the failure nor any corrective actions taken will have any effect on the dates the Contracts were issued, entered into or purchased for purposes of §§ 72, 101(j), 264, 7702 or 7702(A) [sic] and will not subject the Contracts to any retesting or restating of a new test period under §§ 264(d), 7702(f)(7)(B) or 7702A(c).” While this holding largely tracked that of the 2008 Ruling, it subtly added “the failure” as the subject of the material change relief. Why should a section 7702 compliance failure itself need such relief? Perhaps it stemmed from the fact that the contracts were endorsed in the first place, and while that endorsement gave rise to the failure, it also represented a material change. That material change would have produced potentially unwelcome consequences under at least some of the listed statutory rules. It may be that the error in the first set of endorsements provided an opportunity to rectify that situation.

## Concluding Comments

The 2008 Ruling and 2009 Ruling were in large part a repetition of the 2005 Rulings, and hence were consistent with the IRS’s prior ruling position. While the new rulings show that the IRS continues to adhere to its view that the “remittances” and like additions to a contract’s formal cash surrender value are properly considered part of the section 7702(f)(2)(A) cash surrender value, they also show that the agency treats the regulatory requirement in this respect— basically the regulations that have remained in proposed form for over 16 years—as unclear to taxpayers, thus warranting the waiver of the resulting compliance failures. The new waiver rulings, coupled with the 2005 Rulings, further suggest that life insurance companies are taking a conservative approach on this subject, being willing to view the amounts in question as part of the section 7702 cash surrender value even in the absence of published guidance requiring it.

The body of waiver rulings discussed here hint at, but do not directly address, a potentially much more significant subject: the return-of-premium benefits provided under many life insurance contracts today, including term life insurance contracts that do not provide for cash surrender values at all. The 2009 Ruling appears to come closer to this subject than do the others in saying, as quoted above, that the additional surrender benefit with which it was concerned was in part "a function of a return of premiums paid." It may well be tempting to jump from the conclusions of the waiver rulings, and from the all-encompassing formula of the proposed regulations, to judge all return-of-premium benefits to be cash surrender values, or parts of other cash surrender values, within the meaning of section 7702(f)(2)(A). Sound discretion, however, should dictate a more careful consideration of the matter. As a procedural matter, the waiver rulings, being private letter rulings, are not precedential, and the proposed regulations are not effective, as witnessed by Notice 93-37. On the merits, those proposed regulations are all too all-encompassing, extending the cash value definition well beyond the thinking of Congress, which the courts would say should be construed to reflect what cash value, as a term of art, was understood to mean under state insurance law *circa* 1984. When Congress has considered benefits that merely return premiums paid, it has not viewed them in the same manner as insurance or annuity cash values that possess a savings element, and hence it has (as noted above) excluded such benefits provided under credit life insurance from cash surrender value treatment under section 7702, and also it has permitted such benefits under "qualified" long-term care insurance contracts (under section 7702B) while generally banning cash surrender values from those contracts. Hence, while treating return-of-premium benefits as cash surrender values may be appealing to the IRS, the transit from disregarding those benefits to fully recognizing them under section 7702(f)(2)(A) is not a simple matter, or a trip that should be taken lightly.[12]

What, then, is the magic solution? A new regulatory project may be the simplest, most straight-forward way to put to rest all of the outstanding questions. This could involve the issuance of a new notice of proposed rulemaking that updates, revises, and narrows the cash surrender value definition put forth in the 1992 proposed regulations. If this were done, accompanied by the required invitation for comment and by appropriate transition provisions, it would represent a significant step forward in enabling compliance with section 7702.

[1] PLR 200521009 (February 22, 2005); PLR 200528018 (April 12, 2005).

[2] All references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

[3] S. PRT .NO. 98-169, vol. I, at 573 (1984); H.R. REP. NO. 98-432, pt. 2, at 1444 (1984).

[4] Id.; STAFF OF J. COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 648 (Comm. Print 1984) ("1984 Blue Book").

[5] 1984 Blue Book at 647.

[6] Prop. Treas. Reg. § 1.7702-2(b)(1).

[7] 1993-2 C.B. 331.

[8] KENNETH BLACK, JR. & HAROLD D. SKIPPER, JR., LIFE & HEALTH INSURANCE 46 (13th ed. 2000).

[9] JOHN H. MAGEE, LIFE INSURANCE 599 (3d ed. 1958).

[10] There was another private letter ruling addressing the section 7702(f)(2)(A) cash surrender value definition during the interim, but it was not a waiver ruling. That ruling, PLR 200745006 (August 9, 2007), involved a request for an affirmative ruling on the application of that definition, although the redacted version of the ruling released to the public does not disclose much information about the precise nature of the ruling requested or about the insurance product involved. Based on what can be gleaned from the non-redacted portions of the letter ruling, some amount greater than the "policy value" of the base contract would be payable on surrender if the contract was issued with a particular rider. Consistently with its ruling policy on the waiver rulings discussed herein, and citing to the same authorities and rationale as in the waiver rulings, the IRS held that the greater amount payable on surrender needed to be recognized as the cash surrender value for section 7702 purposes.

[11] Interestingly, at times the IRS has been of two minds on the seeming breadth of the cash value definition. The amount a life insurer's deduction for the increase in its reserve for a contract under section 807 is dependent in part on the contract's "net surrender value," which section 807(e)(1)(A) defines as essentially the contract's cash value determined without regard to surrender charges. In audits of life insurers' taxes, the IRS has contended that a contract's net surrender value was less than its full nonforfeiture value, even after reduction for surrender charges, at least where all of that nonforfeiture value could not be realized during the taxable year at issue.

[12] See also National Association of Insurance Commissioners, "Actuarial Guideline CCC – The Application of the Standard Nonforfeiture Law for Life Insurance to Certain Policies Having Intermediate Cash Benefits," relating to inter alia the treatment of return of premium benefits under state nonforfeiture law. This guideline, adopted last year, is applicable "for all policy forms filed on or after January 1, 2009, and affects contracts issued on or after January 1, 2010."

# Return of Premium Term—**Implications of a New Actuarial Guideline**

by Dominique Lebel

*Editors' Note: Reprint courtesy of the Marketing and Distribution Section. This article first appeared in the May 2009 issue of* NewsDirect.

Return of Premium (ROP) Term is one of the hot products in the life insurance market for several reasons:

- ROP Term is easy for consumers and producers to understand.
- Sales pitches such as "money-back term," "did you know that very few policies mature as death claims," and "win-win: insurance protection if you need it, return of premiums paid if you don't," resonate with buyers.
- Quoted after tax rates of return are often higher than alternative investments (e.g., bank certificates of deposit).
- The additional premium for ROP Term translates into additional commissions for the producer.
- Return of premium feature makes the product work for a variety of strategic sales situations such as mortgage funding, college funding, alimony funding, key-man and buy-sell.

ROP Term typically returns increasing percentages of premiums paid if the policy is lapsed. The percentages usually grade from 0 percent at issue to 100 percent at the end of the level term period. The percentages can vary significantly by insurer based on how each insurer interprets the Standard Nonforfeiture Law. In fact, a few companies do not provide any interim cash values; only a full return of premium at the end of the level term period.

A new actuarial guideline, AG XLV (formerly known as AG CCC), was adopted in the fall of 2008 by the NAIC. AG XLV sets guidelines for minimum cash values for ROP Term policy forms filed after Dec. 31, 2008 and policies issued after Dec. 31, 2009.

Under AG XLV, cash values prior to the end of the level term period will generally need to be increased for most current ROP Term products (for some products, current cash values at certain durations could be decreased, but overall, cash values under AG XLV are generally higher than current cash values). This general increase in cash values will likely necessitate an increase in premium rates. The higher the lapse rates assumed, the greater the impact on premium rates. For example, since worksite products generally have higher lapse rates than products sold in other distribution channels, the impact on worksite ROP Term premium rates may be significant.

AG XLV will have other consequences. For example:

- Currently, due to a common interpretation of the Standard Nonforfeiture Law, many ROP Term products have interim cash values that do not vary by underwriting class. AG XLV will cause ROP Term products to have cash values that vary by underwriting class (i.e., by issue age, smoking class, etc.).
- AG XLV has clarified how interim minimum cash values should be calculated for ROP Term products, which should make ROP Term products available in all states. Prior to AG XLV, state regulators interpreted the Standard Nonforfeiture Law differently in respect to ROP Term minimum cash values. This made it difficult to get ROP Term policy forms approved in all states.
- Some companies designed ROP Term products to take advantage of uncertainties in the Standard Nonforfeiture Law in relation to ROP Term products. ROP rider and indeterminate premium designs are two such examples. AG XLV includes language that eliminates the benefits obtained from ROP rider and indeterminate designs. As a result, fully guaranteed integrated designs may replace these designs.

As outlined above, the implications of AG XLV are numerous. Time is short for providers to have competitive products in place for year-end 2009. ◻

*Dominique Lebel, FSA, MAAA, FCIA, is a senior consultant at Towers Perrin. He can be reached at Dominique.Lebel@towersperrin.com.*

# An Integrated Product Approach for the **Retirement Planning Market**

by Jay Vadiveloo and Marianne Purushotham

Insurance companies have always been key players in the retirement planning marketplace, however they have had to compete with banks and other financial institutions for a share of retirement assets. Over the past decade, insurers have more aggressively entered the marketplace through the introduction of variable annuity products with guaranteed living benefit options. This has proved an effective way for insurers to grab a larger share of retirement assets, but the industry has failed to achieve market dominance utilizing its unique core competency, the management of mortality, longevity and morbidity risk.

The current financial crisis is forcing insurance companies to re-evaluate their variable annuity strategies in both the pre- and post-retirement arenas as they struggle with negative balance sheet impacts resulting from deferred acquisition cost write-downs and increased capital and reserving requirements now that guarantees are largely in the money.

Smart insurers have recognized that these turbulent economic times present a huge opportunity for carriers to reposition themselves, and product innovation should be at the heart of their strategy. In line with this thinking, we recently researched, designed and developed a new retirement planning product concept of our own. And, applying our minimal marketing skill to the task of naming this product, we decided on Integrated Retirement Planning Insurance.

## The Integrated Retirement Planning Insurance Product

It is important to note that this is not a substitute for current investment-based retirement products such as variable annuities, but instead would provide for a base level of guaranteed retirement benefits to meet primary needs.

This product utilizes a fund-based approach similar to fixed universal life, where charges are deducted from the fund to cover benefit levels elected. The base product provides for all of the following:

- Monthly income for life.
- An estate upon death.
- Morbidity coverage provided as a multiple of the monthly income for a healthy life.

At the time of purchase, the buyer has the choice of electing a greater guaranteed income (and therefore greater morbidity coverage) in exchange for less guaranteed estate coverage or vice versa. Income payments can be purchased on an immediate or deferred basis depending on the individual's retirement timeframe.

Under this approach, after the deduction of benefit charges, funds continue to grow at a current interest rate. If the current interest rate exceeds the guaranteed level used to determine the initial coverage guarantees, then an excess interest credit accrues to the retiree. The retiree can then apply the excess interest credit in any of the following ways:

- Take the excess interest as cash.
- Purchase additional paid-up estate coverage.
- Purchase additional income and morbidity coverage.

Gains and losses from mortality and morbidity experience accrue to the insurance company and are incorporated in the modeling of the product profitability. While the annual excess interest credits are not guaranteed, if a new layer of estate or income/morbidity coverage is purchased, the amounts are guaranteed for all future years.

Besides offering potential inherent inflation protection, the excess interest credit provides a source of liquidity (it can be taken in cash) as well as the flexibility to balance guaranteed coverage levels between income, estate and morbidity to meet changing retirement needs in the future. An additional indirect source of liquidity is provided through the nonforfeiture value of the estate protection.

Here's why this product makes sense.

First, the actuarial soundness of the design should make it attractive to insurers, producers and customers, especially in today's economic environment. All guarantees are based on conservative assumptions for mortality, morbidity and interest and the underlying benefits are well tested and understood.

Second, natural hedging exists between the underlying risks—longevity, morbidity and mortality—thus provid-

CONTINUED ON **PAGE 30**

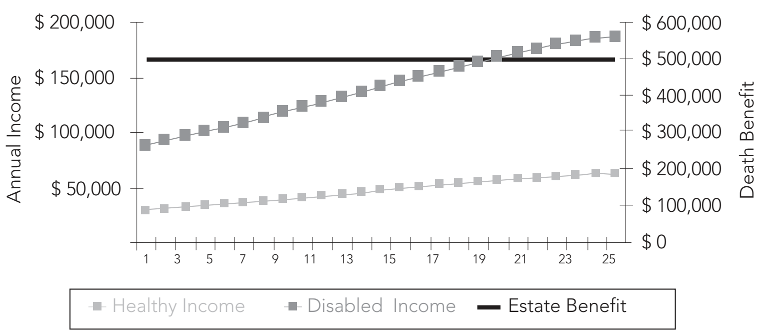
*Jay Vadiveloo, Ph.D, FSA, MAAA, CFA, is head of IFS, Hartford Office & Watson Wyatt Professor, University of Connecticut Watson Wyatt Worldwide. He can be contacted at Jay.Vadiveloo@watsonwyatt.com.*

*Marianne Purushotham, FSA, MAAA, is a consultant with Watson Wyatt Worldwide. She can be contacted at marianne.purushotham@watsonwyatt.com.*

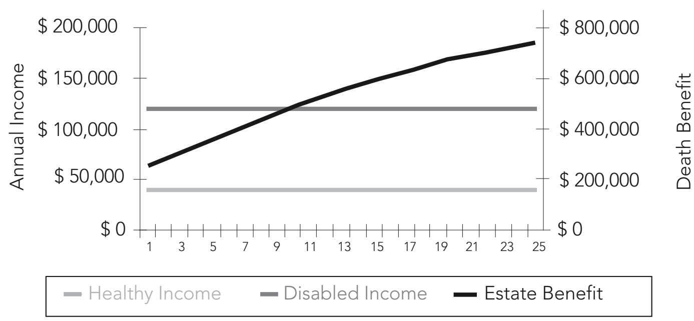
ing superior risk management and asset/liability management opportunities for the insurer. And unlike variable annuities with guaranteed options, this product would not require the purchase of hedges at a non-guaranteed future price, daily portfolio rebalancing, and complex hedge fund accounting to manage the contractual guarantees.

In addition, since coverage is purchased on a paid-up, single premium basis, the financial risk presented by potential anti-selection is minimized, particularly for the estate coverage component.

### Table 1A
### Integrated Retirement Planning Product Benefit Levels
Male 65, Excess Interest Applied to Buy Additional Income




### Table 1B
### Integrated Retirement Planning Product Benefit Levels
Male 65, Excess Interest Applied to Buy Additional Estate




Finally, this product does not require SEC registration and broker-dealer licensing so it can be marketed and sold through traditional distribution channels.

With a focus on customer needs, this product provides the buyer with substantial coverage through a single purchase. As we have conceived it, from the buyer's perspective, this product should offer nothing to distract from the primary purpose of the policy—income/morbidity coverage and death benefit. It should be simple—simple for the producer to explain, simple for the carrier to illustrate, and simple for the customer to understand. No riders, no additional options, no superfluous benefits to complicate the sales process.

## A Simple Illustration

The graphs on the left illustrate the integrated benefits provided on both a guaranteed and current basis under the current Integrated Retirement Planning Insurance product design. The illustrations are based on the life of a healthy male, non-smoker, 65 years old with an initial investment of $1,000,000.

Table 1A shows projected coverage assuming the policyholder elects an estate benefit of $500,000 with the remainder allocated to purchase income/morbidity. All future excess interest credits are applied to purchase additional income/morbidity coverage.

Table 1B shows projected coverage assuming the policyholder elects a set level of income/morbidity with the remainder allocated to purchase estate coverage. All future excess interest credits are applied to purchase additional paid-up estate coverage.

The assumed guaranteed interest rate is 1.5 percent and guaranteed mortality and morbidity rates are based on current reserve assumptions for annuity, life and long-term care insurance coverages.

The current interest rate is illustrated at 4 percent and for illustration purposes there is an initial front end load of 10 percent assumed to cover commissions and other upfront costs.

While benefit levels would vary with an individual company's pricing and product design decisions, these illustrations demonstrate the transparency and potential simplicity of this product strategy. There is no need for the retiree or the financial planner to optimize retirement benefits by choosing between various non-guaranteed investment alternatives. At the same time, on a current assumption basis, the illustration is relatively competitive with similar benefits offered individually in the marketplace.

## Implementation Considerations

All new and innovative product strategies require careful thought with respect to pricing, administration, marketing and distribution issues. A few of the issues that would need to be considered are:

- Choice of assumptions for pricing the guaranteed coverage levels and the impact on pricing and marketability.
- Choice of compensation structure and training approach for various distribution channels.
- Development of actuarial formulas based on multiple decrement probabilities.
- Understanding natural hedging impact—Insurers may be able to incorporate the natural hedging that occurs between estate protection and annuity/morbidity benefits. This natural hedging could reduce capital and reserving requirements for the integrated product as compared to the sum of the capital and reserves that would be held for the same individual coverages determined on a non-integrated basis. However, modeling is required to understand the appropriate degree of reduction and secure the necessary regulatory approvals.
- Asset/liability management for the integrated strategy—This may be challenging since the liability cashflows for the integrated strategy will not be the sum of the liability cashflows for the individual coverages on a non-integrated basis. However, appropriate analysis of the integrated liability cashflows may lead to the development of an investment strategy which significantly improves product performance.
- Operational issues such as the administrative structure required to manage the determination of excess interest credits, financial reporting requirements, etc., would need to be reviewed, and the approach could vary from company to company depending on the existing administrative infrastructure available.
- Tax considerations always arise when insurance products with different tax treatments are integrated. It is important to point out that this product was not conceived as a tax planning strategy, but instead as an integrated financial planning coverage to meet all the needs of retirees.

There is an old Chinese saying which states, "where there is chaos, there is opportunity." The financial services industry is in crisis today and clearly the survivors of this crisis will be those companies with sufficient capital and surplus to ride out the storm. But the beneficiaries of this crisis will be those companies that create new opportunities for themselves through research and introduction of innovative new products and services.

We believe an integrated product that provides for the primary needs of the retirement market on a guaranteed basis is a good example of the significant potential that exists for insurance companies to take a leadership position in the retirement marketplace. ■

SOCIETY OF ACTUARIES

Product Development Section

475 N. Martingale Road, Suite 600
Schaumburg, Illinois 60173
p: 847.706.3500 f: 847.706.3599
w: www.soa.org

Product Matters!

Non Profit Org
U.S. Postage
PAID
Carol Stream, IL
Permit No 475