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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 They have served the industry well, but they now appear to be outdated and obsolete.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
$1 Million Death Benefit
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

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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.

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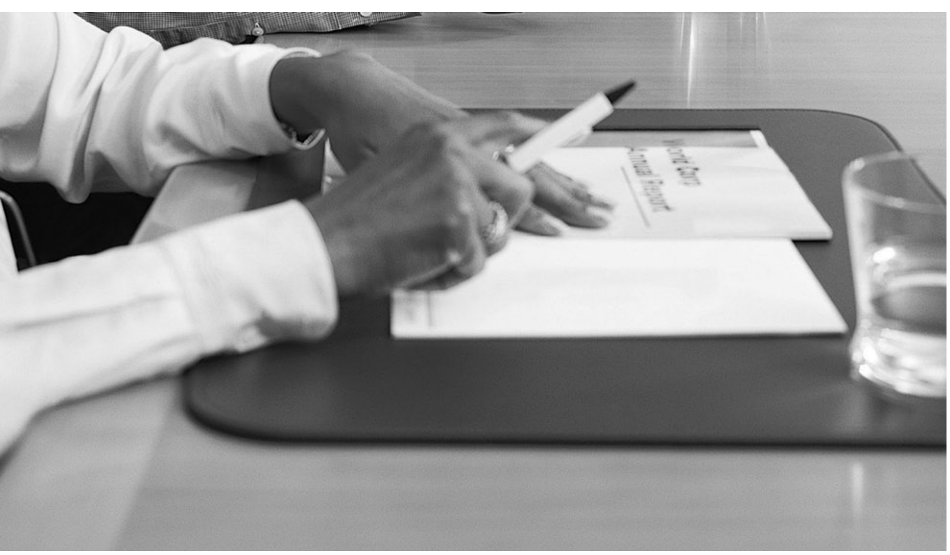
- Another possibility could be to remove the current inconsistencies in treatment that exist between the various laws. A whole life product is a whole life product whether it is on a universal life chassis or an individual chassis. If it is possible to nearly eliminate cash values for whole life on a 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. ◻