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The Future of Life Insurance Products: Lessons from the Past

by Christian DesRochers

As the Society of Actuaries celebrates its 50th anniversary, it is instructive to consider some of the changes that have occurred and those that have not occurred in the life insurance products over the past 50 years. To say that we are not the same industry as we were 50 years ago is an understatement. There have been significant changes in technology and communications that have affected all industries, including life insurance. With the conversion of many mutual life insurance companies to stock life insurance companies, we are seeing a change in structure that goes back to the very beginnings of the life insurance industry in the mid-1800s, as well as the reforms made in New York in the early 1900s by the Armstrong Committee. The most popular forms of life insurance are not the traditional whole life products of the past, but are newer forms of policies, including universal life and variable universal life insurance.

In the midst of this change, however, not everything is new. Although many of the products have been updated and contemporary products have more flexibility than their historical counterparts do, the basic structure of life insurance products (and the life insurance contract) has not changed in the past 50 years.

Many of the changes that have occurred have been directed at more customization of existing products and not the development of fundamentally new products. There are more underwriting classes today than in the past. This includes not only the differentiation of smokers and non-smokers, but also the addition of preferred underwriting classes. Products have becomes more flexible. There is little economic difference between modern participating whole life insurance policies structured with term and paid-up additions riders and universal life insurance. Both provide flexibility to the buyer in terms of the flow of funds to the insurance company. Both can provide a degree of flexibility in the policy costs.

However, all contemporary life insurance products exist within a framework that is more than 50 years old. There are two fundamental parts of the current framework in which all life insurance product development occurs. These are: (1) the standard nonforfeiture law and (2) the preferential tax treatment of life insurance found in sections 101(a) and 72(e) of the Internal Revenue Code. Without fundamental changes in both, the past will continue to be a prelude to the future of life insurance products.

Nonforfeiture Values

THE DEVELOPMENT OF contemporary nonforfeiture values can be traced back to the first state nonforfeiture laws in the 1860s. The current nonforfeiture structure, the prospective adjusted premium method, has its roots in the 1942 work of the Guertin Committee. Before that time, nonforfeiture values were generally based on reserves. Within a few years after issue, the full reserve held under the policy was often made available to a terminating policyholder, reduced by a surrender charge. Under competitive pressures, liberalizations occurred until the early 1930s during the Great Depression when increased terminations, reduced interest margins, increased taxation of life insurance companies, and the depressed economic conditions generally led to a reduction in surrender values. The work of the Guertin Committee in the early 1940s was intended to address the equities of granting surrender values between terminating and persisting policyholders. It is from this effort that the current system of mandated minimum nonforfeiture values arises. Although changes have been made in the required assumptions, there has been no fundamental change in the methodology arising from the Guertin Committee work in the early 1940s.

While changes to the nonforfeiture law have been proposed from time to time, the actuarial community, the life insurance industry and its regulators have yet to agree on the scope or structure of a revised standard. As the Society of Actuaries celebrates its 50th anniversary, it is notable that the fundamental structure under which life insurance cash values are provides to policyholders has been fundamentally unchanged.

Tax Preference for Inside Build-up

THE SECOND ELEMENT that indirectly governs life insurance cash values is the tax treatment of life insurance under the Internal Revenue Code. Unlike the nonforfeiture law, the tax treatment of life insurance has changed fundamentally since the 1940s. The result is that the current products, as well as the way in which those products may be financed, has been significantly limited. The result is that the variety and flexibility of life insurance products has been curtailed since the 1940s, with entire classes of products effectively eliminated from product portfolios.

While the most significant change in the taxation of life insurance was the enactment of the definition of life insurance in 1984, there were a number of changes in the tax treatment of life insurance policies that restricted product design and marketing throughout the period. Most of the changes can be attributed in one way or another as congressional reactions to specific life insurance products. These include:

- The Revenue Act of 1942 eliminated the deduction of policy loan interest paid to purchase a single premium life insurance policy. This limited the sale of single premium policies, which had been popular in the late 1930s and early 1940s.

- As a response to the 1942 limitations, the life insurance industry used a premium deposit fund and an annual premium policy for financed single premium policies (interest on premium deposit funds was not taxable to the insured). The Internal Revenue Code of 1954 limited the use of advance premium deposit funds to pay "substantially all" of the premiums for a life insurance policy.

- In 1964, in response to the sale of minimum deposit policies with advance premium deposit funds, the deduction for policy loan interest was limited to policies under which no more than three of the first seven premiums were paid using a policy loan.

- In 1982, in response to universal life insurance policies, Congress enacted section 101(f) of the Code, which provided a definition of life insurance for flexible premium life insurance.

- In 1984, Congress enacted section 7702, which extended the 101(f)-style limitations to all life insurance policies. Section 7702 effectively eliminated endowment policies maturing before age 95, as well as other forms of high cash-value plans, including retirement income policies.

- The Tax Reform Act of 1986 eliminated the deduction of policy loan interest by individual taxpayers, thus effectively eliminating the individual financed insurance or "minimum deposit" market. The deduction of policy loan interest to corporations was limited to a $50,000 loan per insured employee.

- In 1988, responding to the increased sale of single premium life insurance policies, Congress enacted the modified endowment rules in the Technical and Miscellaneous Revenue Act.

- In 1996, the deduction of policy loan interest was phased out for corporations, with interest effectively nondeductible after 1998.

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Whether the "abuses" that Congress sought to eliminate were perceived or real is a matter of one's perspective. However, the numerous legislative changes related to the tax preferred treatment or the interest earnings inside a life insurance policy limit product flexibility. Currently, the section 7702 limitations serve as the mirror image of the nonforfeiture law. The nonforfeiture law mandates an actuarial floor on the allowable cash value based on the insurance benefits to be provided and the pattern of premium payments. The section 7702 limitation provides a ceiling on the allowable cash value. For products in which the cash value floor exceeds the tax law ceiling, the product simply disappears from life insurance product portfolios.

A View of the Future

WHAT IS THE net outcome? There are, I believe, two consequences of the relationship between the nonforfeiture and tax code limitations. First, the range of allowable products is narrow. All life insurance products must function between the two limitations, and there simply isn't much room to operate. Second, the probability of meaningful reform of both the nonforfeiture law and the tax definition to allow a wider range of permissible products is low. Thus, the current product structure, with all of its complexity and limitations, is likely to continue for the future.

One thing that could alter the status quo would be a change in the current life insurance tax preference. This could occur as a consequence of a change in the tax law to a consumption tax, in which case no interest would be taxed, thus eliminating the need for special limitation on life insurance. It could also occur as the result of the direct imposition of a tax on the interest earnings in a life insurance policy. However, as Professor Joseph M. Belth wrote in 1978, "the implications of taxing the inside interest are scary" and is not a prospect that the insurance industry would accept willingly.

Because of the dual limitations, life insurance companies are faced with the reality of continuing to refine the current portfolio of products within the existing tax and regulatory framework. If we have managed to do so for the first 50 years, perhaps we can manage to do so for the next 50.

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