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Small Talk

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The Strategic Importance of Inter-Company Mortality Studies

by Narayan Shankar

Broad-based mortality studies form the backbone of the life actuarial profession. Credible data is a big part of our profession's credo, "To substitute facts for appearances and demonstrations for impressions." However, few companies have sufficient exposure or deaths to construct their own mortality table. Even if some large companies have enough data, we are still left with a vast majority of companies that do not. Historically, the void has been filled by means of inter-company studies.

The Benefits of Inter-Company Mortality Tables

Insurance companies have become insolvent for a variety of reasons, most commonly due to losses on their asset portfolio. But few companies have encountered solvency problems due to adverse mortality experience. A number of factors have contributed to this impressive record of more than a century of experience. But it is due in no small measure to the standardization of underwriting practices and the accurate measurement of mortality rates pertaining to the underwritten insured population by means of inter-company studies.

The following are a couple of the major benefits of inter-company mortality tables:

- Actuaries have been able to price insurance products with confidence, knowing that they can correctly capture their own company's experience by making only simple adjustments to the level of mortality rates obtained from industry-wide experience. This allows insurance companies to offer the best premiums to customers, without the larger risk loads normally necessary when pricing with out credible data.
- The financial health of life insurance companies, vital for the personal security of millions of Americans, has been assured, due to the ability of regulators to set appropriate tabular mortality standards. Valuation tables that contain adequate margins of safety without being onerous have only been possible because of accurate inter-company studies that capture insured mortality experience.

While inter-company studies have played a major role as described above in ensuring the health of the life insurance industry, other factors have also contributed. One factor is the care and professionalism with which actuaries have performed their vital function in insurance companies. Another factor is the steady improvement in longevity, which contributed increasing margins to premium rates over most of the last century.

Changes in the Environment

We now describe some changes in the environment that make inter-company studies more important than ever—at the same time that these studies have become increasingly more difficult to conduct.

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Actuaries
The Best-Kept Secret in Business™

Editorial

by James R. Thompson

James R. Thompson is the newsletter editor and is employed with Central Actuarial Associates. He can be reached at 815.459.2083 *or at* jimthompson@ameritech.net.

Our industry continues to have many interesting developments. This newsletter attempts to provide readable and timely information on those issues which particularly impact smaller companies but often impact everybody equally.

This time the trends seem to concern mortality, low interest and taxation. Our lead article is by Narayan Shankar of the SOA staff on the general importance of mortality tables. In general, smaller companies do not have the time and staff to spend on studies and also may lack credibility due to size. Thus, they depend on industry studies more so than larger companies. This is an issue we should push.

Mortality is something which affects reinsurers, as Don Maves points out in his article, "Highlights of the March 2005 NAIC Life and Health Actuarial Task Force (LHATF) Meeting." As you can see, LHATF has its plate full. Of note, under *New Valuation and Nonforfeiture Mortality Table for Preneed Life Insurance*, the SOA has a task force that is about to send out a request for data. They wish to develop a new table for tax reserve and section 7702 purposes, which should have sufficient margins to cover the heavily substandard mortality in the preneed market. I have attended LHATF meetings over the years and helped push for this. If we have an "official" table, we can use it for tax reserves. Many smaller companies are in the preneed market, so we have a special interest in cooperating to make this a reality.

In line with this, we also have two articles on simplified issue (SI)—"Product Development Considerations for a Simplified Issue Product" by Edward Hui and "An Introduction to Simplified Issue" by Michael Agan. For those not in the market, these provide a summary of the unique considerations. We are thankful to have two articles on a popular market with smaller companies. At the opposite end of the mortality spectrum is "Triple X" term insurance and term UL (covered by Guideline AXXX, that is 38). Howell Pugh has an article, "A New Look at Reinsurers and Term." This deals with the issue of possible mortality mispricing. If smaller companies are in this market, they are relying on reinsurers. Read this to help avoid surprises!

We have been following the lower-interest environment. This affects all life companies and Brad Leonard has written an article showing us the trends in valuation and nonforfeiture interest rates. You should receive this newsletter before June 30, 2005, so this will still be an open issue.

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Over the last 20 years, underwriting practices have undergone substantial changes, and this trend is continuing. The developments in technology for the electronic capture, storage and distribution of information have resulted in a wide array of new underwriting tools. Clinical studies have identified reliable markers of potential health problems, which can be used to classify risk. New knowledge is continuously being created in this area. As a result, underwriting and risk classification is not quite as standardized across the industry as it used to be. Companies experiment frequently with new risk classes and attempt to use them as a means of gaining competitive advantage.

So far, inter-company mortality studies have not offered any help in dealing with these new developments, as there are no tools for separation by risk class or underwriting results in the studies. Companies find themselves in the situation of pricing with less than perfect data. At the same time, intense competition often makes it necessary to forego the bigger risk margins that are normally used when pricing in these situations. A mitigating factor for many companies is the fact that they have reinsured a significant portion of the mortality risk.

Reinsurers, due to their ability to pool the mortality experience of many companies, may have a better knowledge of underlying insured mortality and trends than most direct writers. Many direct insurers are in the situation that they "back" into the mortality level they use for pricing their policies based on the reinsurance premiums they are charged. This creates a situation of information asymmetry between the contracting parties in a reinsurance agreement. Direct writers can be at a disadvantage under these circumstances, especially in an environment with fewer reinsurance companies and expanding demand for reinsurance.

It appears that most actuaries do not have a good idea of the slope of mortality in the current environment — they seem to have only a general idea of the overall level of mortality. A weak and shallow knowledge in the actuarial community of mortality levels, trends and slopes is not healthy for the profession. This can stifle innovation, since the lack of data prevents actuaries from engaging in "data-mining" to get new ideas for risk classification and underwriting techniques.

We live in a time when changes in medical technology, genetic engineering and other developments have the potential to further change longevity trends. Due to the aging of the population and changing insurance needs, the age of the life insurance applicant may be higher in the future than it has been historically — this presents new challenges in actuarial pricing. Good mortality data with accurate measurement of trends and slopes is vital for meeting these challenges.

The comfort of laying-off most of the mortality risk through reinsurance can come to an end, leaving direct writers in the uncomfortable position of pricing products without adequate data and being forced to retain a bigger portion of the risk.

Regulators, frustrated with the difficulty of establishing tabular mortality standards and formulaic reserves in this rapidly changing environment of product innovation, could delegate the function entirely to the actuary. If that happens, actuaries can suddenly find themselves in the

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Income taxes and policy structure are also issues: The March issue of the Product Development Section's Newsletter contained an excellent article, "Notice 2004-56: Guidance on Mortality under IRC section 7702," by John Adney and Craig Springfield. I instantly recognized the significance of this article co-authored by John Adney, who is an attorney —being one of the foremost authorities on tax law for over 20 years. This deals with reasonable mortality charges. Because 2001 CSO has been the 26-state mortality table, the IRS felt the need to issue this. Also, Ed Robbins has written an article on a new revenue ruling that favorably affects family term riders. Smaller companies often have these traditional riders, and this is especially good news for us.

We also wish to highlight the educational endeavors of the Smaller Insurance Company Section. W. Howell Pugh has written an article on the sessions for the SOA's upcoming Annual Meeting that our section is sponsoring or co-sponsoring. The Annual Meeting will be held in New York from November 13-16, 2005.

I am in charge of the Smaller Company Issue at the Valuation Actuary Symposium this September 22-23, 2005 in Orlando. We customarily run a panel discussion with heavy audience participation on several issues of interest to us. The issues will be settled upon closer to the meeting. The article shows the program as of the date we are writing this (end of March).

Finally, we are happy to have a letter to the editor from Tom Herget concerning the article on gross premium valuation (GPV) published in our November 2004 issue. His comments helpfully add to that article. We are always happy to have responses to what we publish. ●

Companies can also create new risk classes by experimenting with the data, vastly expanding the opportunity to innovate.

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situation of determining the appropriate mortality assumption for their company's business, without enough data to make a decision for which they are comfortable. They would need to justify their decisions to regulators, as well as to the management of their companies. With insufficient supporting data available to the actuary, company management could exert intense pressure to set reserves at a level below an actuary's comfort level.

Possible Solutions

Reinvigorating inter-company studies can have a very positive effect in addressing these problems. By cooperating, everyone can win. It will be good for the consumer, foster innovation, maintain and improve insurance company financial strength and facilitate regulation by allowing it to focus on the right issues. But it will happen only if many more companies participate in the studies and go the extra mile in contributing new types of data that are not collected presently.

For inter-company studies to solve the problems described, the design of the studies will need to change. The focus will have to shift away from simply publishing standardized mortality tables each year. Since underwriting policies and risk classifications vary significantly across companies, standardized tables are of limited value. However, the data collected on each policy during the underwriting process, such as laboratory test results, can be submitted to the inter-company study. When these underwriting data are pooled across many companies and analyzed against mortality experience, a detailed understanding of the mortality that can be expected for various values and combinations of test results can be obtained. If this database is made available to each company, the company can customize its mortality analysis to the types of laboratory tests it uses in its underwriting and the ranges of test values that are used to define its risk classes.

Under proposals currently under consideration at the SOA, the new studies will emphasize the collection of underwriting data—the lab test results and other information compiled at the time of underwriting will need to be submitted to the inter-company study. This data will be pooled across all companies, as well as the deaths arising out of this exposure.

The proposals call for the expanded data, described in the previous paragraph, to be made available to all companies, for them to do their own customized analysis of the data. Of course, to ensure privacy, any markers that will permit the individual identification of policyholders or the company will need to be deleted. By slicing and dicing the database to fit their own underwriting criteria, a company can determine the expected mortality experience for its unique risk class definitions. Companies can also create new risk classes by experimenting with the data, vastly expanding the opportunity to innovate.

Annuity Products

The previous discussion focuses on life insurance. But there is a growing strategic importance to annuitant mortality.

The demand for income annuities is expected to expand in the future. Defined contribution pension plans have been slowly replacing defined benefit plans for two decades. As a result, future retirees may need to annuitize a portion of their pension account balances to manage longevity risk. When a large number of customers seek income annuity products, it will be necessary to develop refined annuity tables in order to offer substandard annuities that meet the needs of the marketplace.

The higher demand for income annuities will occur at a time when mortality trends will be more uncertain than ever. The older ages are of greatest interest from an annuity perspective. New technologies and medical breakthroughs hold out the prospect for a substantial increase in life expectancy. But there are also theories that predict that mortality improvement will slow down in the future. It is possible that the effects of the scientific advances will be slower to materialize.

There has been no industry-wide experience study of individual income annuities for almost two decades. It will be necessary to perform a study to develop a good baseline against which trends to monitor going forward. The SOA recently initiated a new annuity study. The actuarial profession should stay on top of mortality developments, at both the theoretical and practical levels, in this crucial area.

Conclusion

Inter-company mortality studies are of considerable strategic importance for the life insurance industry. We should ensure that these studies occur on a timely basis, keeping with innovations in product design, as well as information technology. By remaining relevant, flexible and offering the new levels of access to inter-company experience made possible by technology, these studies can benefit consumers, actuaries, regulators and—not least—support the financial health of the life insurance industry. We have a glorious tradition of cooperation for the common good; inter-company studies have clearly served the public interest. We now need to take the crucial steps necessary to ensure that the studies will enable us to meet the new challenges we will face in the coming years. ●

News From The Chair

by Terry M. Long

It does not seem possible, but as I write this first article as chairperson of the Smaller Insurance Company Section, my term is almost half gone. There have been plenty of section-related activities but most have not been visible to the members. As most of you are aware, the SOA has adopted a new strategic plan. This plan not only impacts how the SOA is organized and operates, but it means significant changes in the responsibilities of the sections. These changes, and the related transition, have posed a number of challenges but will ultimately provide more opportunities for the Smaller Insurance Company Section to better serve the needs of our members. I am looking forward to helping implement these changes during the rest of my term on the council.

While it is months late, I would like to take this opportunity to publicly thank the council members, whose terms ended last October, for their time and effort, as well as their continued assistance to me. A number of the activities on our agenda this year were started under the leadership of Pete Hitchcock, the former section chairperson. Kent Scheiwe and Tammy Kapeller are the other outgoing council members. All three of them continue to serve the section as Friends of the Council, which I will discuss more later. Pete is currently part of our Membership Team, while Kent and Tammy are assisting with the SOA Spring Meetings.

Due to changes in personal circumstances, two other council members—Steve Frechtling and Don Hagen—resigned from the council last October. I would like to thank Steve and Don for their service and contributions during the time they were able to be a part of the council.

I would also like to thank the rest of the council members for their time and effort. Phillip Velazquez is the vice chairperson, Julie A. Hunsinger is the secretary-treasurer and Susie L. Keisler-Munro is coordinating the first session sponsored by our section at the Spring Health Meeting. The new council members are Paul Carmody, W. Howell Pugh, Jeffrey S. Morris, Todd R. Sagmoe and Arthur J. Verney.

As one of the smaller sections, the changes in the SOA structure mean we will need to work more closely with other sections, as well as rely on even more volunteers from the section to complete activities that were once the responsibility of the Practice Areas. We have already begun working with other sections as a number of our sessions at the Spring and Annual SOA Meetings are jointly sponsored with other sections. Additionally, we will be working with other sections on research projects and experience studies. Two ways we have identified to increase the number of volunteers available are the establishment of the Friends of the Council and a concerted effort to increase the number of section members.

Other sections have successfully used the Friends of the Council concept for a number of years. The Friends of the Council are section members who, while not currently on the council, participate in the monthly council conference calls, receive the section minutes and volunteer to assist with section projects. While many of the current Friends are former council members, that is not a requirement. Not only will participating as a Friend of the Council provide volunteer opportunities, it can also provide you an opportunity to learn about council roles and responsibilities before running for a council position. I invite any section member who would like to be a Friend of the Council to contact me or any of the other council members for information.

Our membership team is headed by Paul Carmody. The primary objectives of the membership team are (1) to increase the number of SOA members who are members of the Smaller Insurance Company Section and (2) to expand our membership to include non-actuaries who are employed by smaller insurance companies. Many actuaries who do not consider themselves to be employed by a smaller insurance company face challenges, such as limited resources, that are similar to those faced by actuaries employed by companies that are considered to be small. Many of these actuaries have not considered joining our section when, in my opinion, they could benefit from our activities. Conversely, they could contribute to our current members by sharing their experiences and increasing our volunteer base.

Last fall, we changed our section bylaws to allow non-actuaries to join our section. These members would not have voting privileges nor could they serve as council members. In all other respects, however, they can participate in section activities and serve as volunteers. This change will allow companies who do not have an actuary on staff to stay abreast of current activities through the Smaller Insurance Company Section. Paul and the rest of the membership team will be contacting non-actuarial organizations that serve smaller insurance companies to make them aware of our section and the membership opportunities available to them.

Other activities we have planned for this year are the publication of *Small Talk* in November and planning for the Valuation Actuary Symposium, the Smaller Insurance Company Chief Actuaries Open Forum and the SOA Annual Meeting. We are always looking for articles, or suggestions for articles for the newsletter, and welcome your contributions. If you have an article you would like to have included in the newsletter, please contact James R. Thompson or one of the other council members. Planning for the fall meetings is well under way, but since at least one of our sessions at each meeting is an interactive session, we can add or change discussion topics if there is a need to do so. Additionally, we have several openings for speakers at each of the meetings. Again, if you have a topic you would like to see addressed at a meeting or if you would like to volunteer as a speaker, please contact one of the council members.

The year 2005 will be a year of challenges, but with the volunteers we currently have, as well as the support of other section members, I am confident we will meet those challenges and our section will become stronger and more responsive to your needs. ●

Terry M. Long, FSA, MAAA, is senior vice president and principal of Lewis & Ellis, Inc. in Overland Park, Kan. He can be reached at nshatlong@lewisellis.com.

Product Development Consideration for a Simplified Issue Product

by Edward Hui

Recently, there has been an increase in the product development of simplified issue (SI) products in the United States. In the past two years, Gen Re LifeHealth has reviewed over 40 such products, ranging from vanilla direct-marketed products to high-end single premium immediate annuity (SPIA) paid universal life products.

The growth in SI product can be largely attributed to new markets, new underwriting and the current economic environment. Nontraditional markets continue to grow, particularly in the financial sector. Insurance companies are looking to expand through investment broker and financial advisor channels and banks are looking to grow their presence in the insurance market. These channels have ready access to the wealthy and "baby boomer" markets and companies need SI products that are simple, easy to sell and fit well with their portfolio of products. Also, new tools have emerged recently, such as oral fluid tests, teleunderwriting and pharmacy database underwriting. Many of these new underwriting tools are fast, simple and non-invasive. For some SI products, applications can now be processed in less than 24 hours. Finally, the current economic environment of high costs and low interest rates have prompted some employers to use worksite products, to help improve mortgage term sales.

The combination of these items along with the occasional exciting new markets has helped breach new markets with a potential for higher growth. However, an SI product is often riskier than a fully underwritten product. It is important to stress that although SI products are simple products, due diligence is key to development and ongoing profitability. Said another way, do it well or not at all.

Principal Risks

SI products are essentially simple products in a nontraditional market with simplified underwriting. So the two main risks are market penetration risk and underwriting/mortality risk. Gen Re has seen instances where actual volume was one-tenth of the level expected by the direct company, and where mortality and lapse rates were well over double the assumptions used. For example, an SI product (not a burial expense product) was reviewed where experience ran at over 300 percent of the 65-70 Society of Actuaries' Ultimate Table due to liberal underwriting. At these levels, estimating mortality can be more of an art than a science, and with the resulting high premiums, there comes a point where one might ask whether the product is worthwhile to healthy policyholders. We have also seen accounts where there was a high volume of business with better than expected mortality and lapse rates. In all of these examples, results could have been improved with better initial and ongoing due diligence.

Where SI Makes the Most Sense

To those looking to reach a market with a new SI product, I have the following recommendations:

- **Niche Markets**
  SI programs work best in niche markets. There are at least two requirements: a market with preferred risks, and a market where a fast, simple sale is needed. Preferred risks can be groups, such as those actively at work, those with mortgages, the wealthy or affinity groups. Preferred markets are an excellent means of mitigating the risk of high anti-selection, while groups without preferred risk lead to heavy anti-selection. Groups that do not need a fast and simple sale will not accept the trade-off or higher premiums.

- **Definite Value to the Customer**
  The product should fulfill customers' needs and be reasonably priced relative to competitors in that market and other similar markets. If customers do not believe the product has reasonable value, healthy lives will switch to the next fast/simple product that has more value. Ensuring value to the customer will limit selective lapses and unwanted distribution risk.

- **Sellable to the Field Force**
  Make sure that the SI products are understood by producers and fit with their portfolio of products. Financial agents do not want to jeopardize the client relationship if

insurance coverage is denied, particularly when insurance is secondary to the relationship (in many cases, prescreening helps preserve the relationship). Thus, having the commitment of producers increases the chances that desired premium levels are achieved.

Underwriting

The backbone of an SI program is underwriting. With existing SI markets, underwriting is based largely on existing guidelines and tools. However for new SI markets, determining underwriting guidelines and tools can be quite a challenge. Even for existing SI markets, staying abreast of new risks and underwriting tools is necessary to ensure that the product continues to perform well.

Choosing the right tools. Today there is a wide range of underwriting tools for SI programs, including teleunderwriting, motor vehicle reports, oral fluids and pharmacy database underwriting. To maximize performance of the product, consider the process in Figure 1 on page 8. The key points are to identify market needs and risks, evaluate and choose the tools, set limits, estimate morality and keep adjusting and stress testing price until profit measure are most supportable.

Producer concerns. When evaluating underwriting needs of the market, producers are looking for speed, price, approval rates and administrative ease of underwriting. For approval rates, in certain markets it is very important that the SI product could be sold to almost all potential buyers. When considering administrative ease of underwriting, think about whether underwriting is transferable to an agent and whether or not it is invasive.

Risk profile of the market. Assessing the risk profile of the SI market is crucial to choosing the right underwriting. For a fully underwritten product, the level of underwriting adjusts depending on the risk level. For example, a $10 million application on a 65-year-old would have much higher levels of underwriting than a $100,000 application on a 35-year-old. With SI products, there is often just one level of underwriting (hopefully targeted to one tightly defined market, so the risk profile of the market needs to be very well understood when setting underwriting requirements). AIDS, alcohol abuse and avocations are big risks at younger ages; for older ages, the principal risks are related to medical conditions. Impairments such as cancer, heart attack and stroke can still present a high risk five years or longer after policy issue, so when appropriate, be sure the questionnaire extends beyond five years. It is also key to know what type of anti-selection is common in your market. How valuable is the sentinel effect? Will there be selective lapses due to other more competitive products? What is the distribution risk of this product if there is a high concentration at older ages, large amounts and highly residual standard cases?

Assessing the risk profiles of the SI markets is crucial to choosing the right underwriting.

Popular underwriting tools. When evaluating and choosing underwriting tools, consider protective value, cost, speed and administrative ease of underwriting. Depending on the needs and risks of the market, each program will weigh these four factors with different importance. The most popular underwriting tools for SI products are listed on page 9:

- Application
- Attending physician's statement (APS)
- Home office (urine) specimen (HOS)
- Medical Information Bureau (MIB)
- Motor vehicle report (MVR)
- Oral fluid testing
- Pharmacy database underwriting
- Teleunderwriting

Setting limits. Finally, once the underwriting tools are chosen, determine age, amount and table rating limits. Limits will be raised by market needs and restrained by the risk profile and price of the product in the specific market. Distribution risk and anti-selection are always concerns when setting limits: however, there could be alternative modifications such that both parties (applicants/agents and insurers) are satisfied. If a high approval rate is very important for the product, consider including a conservative substandard class. If older ages or higher amounts are key, consider offering lower policy amounts at older ages.

Overall Profitability

The previously mentioned considerations focus on developmental stages of the SI product. However, continued risk management is equally important. SI products have the risk of high mortality, so mortality, lapse rates and distribution experience should be continually monitored. Producer's needs, emerging underwriting tools and the fast-changing competitive environment should be monitored to prepare for the next version of the product. ●

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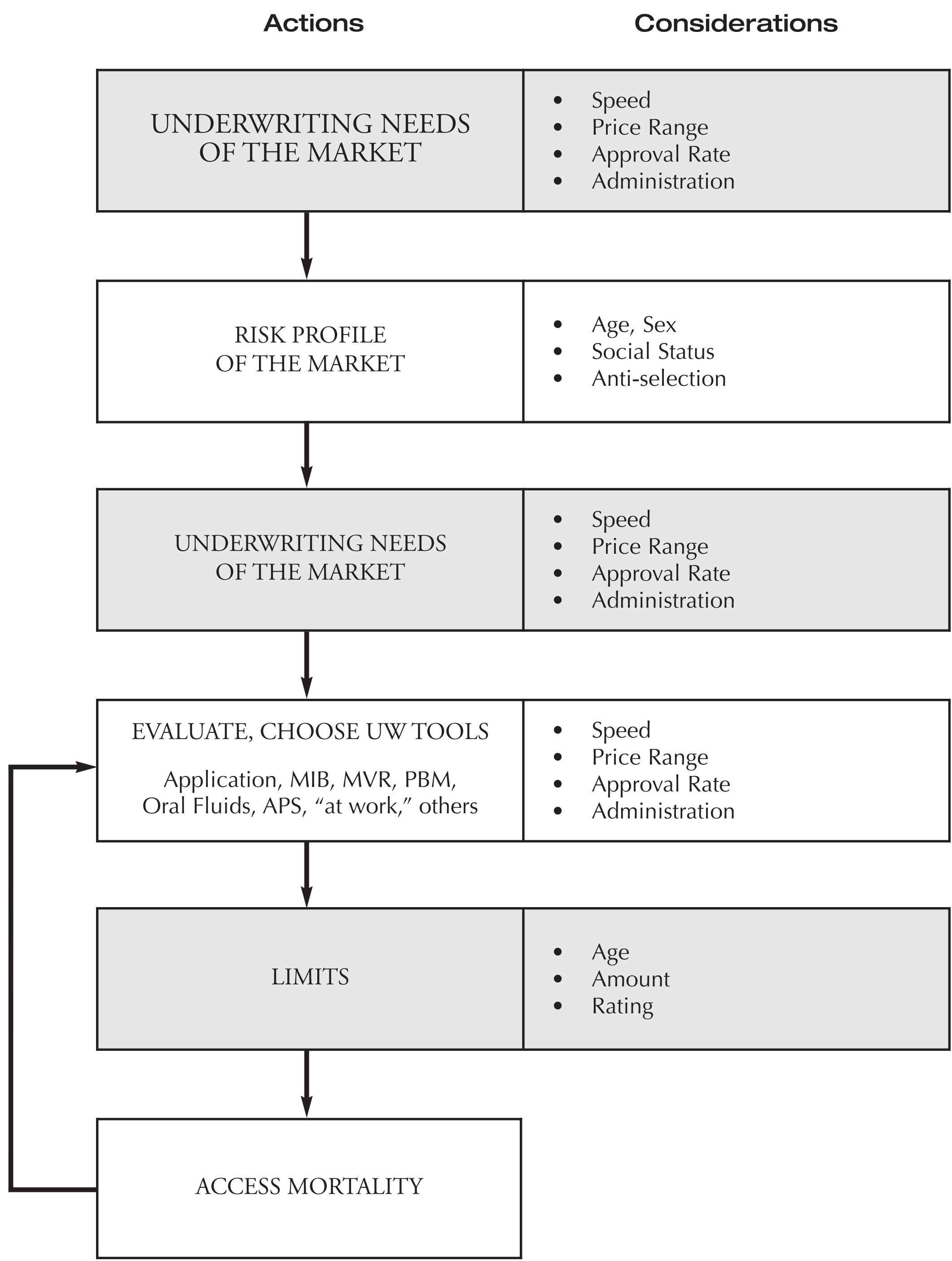
Figure 1:
Process for Maximizing Product Performance



September 2005 Valuation Actuary Symposium Meeting

Smaller Company Issues IF

Moderator: Jim Thompson
Panel: TBD

This interactive forum provides an opportunity to discuss issue of particluar interest to smaller insurance company actuaries along with new solutions and techniques.

Topics include:

- Revisions to the Actuarial Opinion and Memorandum (AOMR)
- Impact of 2001 CSO
- New Annuity Standard Nonforfeiture Law
- Operating in a low interest rate environment
- Impact of Sarbanes-Oxley and corporate governance
- Product update, including term insurance and non-life products

At the conclusion of this session, participants have a better understanding of the issues facing smaller company actuaries.

This session is designed for participants who have **moderate experience** with the subject.

Session Coordinator: Ed Jarrett

An Introduction to Simplified Issue

by Michael J. Agan

What is simplified issue (SI)? Is it the life industry's answer to faster turnaround and better market penetration? When is it used? How is it marketed?

This article explores SI as a product. There is a small-company slant toward SI whole life because the vast majority of my experience with SI is in the senior market. However, most of what will be discussed still applies to all SI.

From the life insurance perspective, SI is the purchase and processing of a "no frills" life insurance policy for the average consumer from point of sale through issuance of a paid policy. It is providing life insurance in a fast, economical, non-invasive manner.

There are three ingredients that define SI: 1) A simple product, 2) a simple underwriting process and 3) quick issue. Each of the previous items will be discussed in more detail.

A simple product is both consumer and agent friendly. A "what you see is what you get" outcome is necessary. A fully guaranteed product not requiring illustrations is a great start. A specified premium is paid, the death benefit, cash values and so forth are known at issue. There is no confusion over credited interest rates, no current versus guaranteed values. A simplified product is "no frills" life insurance.

Simplified underwriting is as important as the simple product design. Simplified underwriting demands a rapid review and an immediate decision. Underwriting should be minutes, not hours or days. This is accomplished with an appropriate balance of an effective application and efficient underwriting tools.

The third ingredient involves the speed of policy issuance. The policy must be issued quickly to complete the SI process. The quicker the policy is issued, the better. What is quick issue? If a fully underwritten policy takes "on average" 30 days to issue, an SI policy should take less than five.

Now that we have defined SI, what are the markets? SI lends itself to "niche" markets. It frequently appears in the mortgage, final expense, financial institution and work-site markets. Each of these markets demands different product offerings and selling techniques.

The mortgage market is characterized by a P&C or a bank cross sell. The final expense market is focused on aging baby boomers and seniors. The financial institution market will utilize platform salespeople or directly market to their customers. Worksite is characterized by easy enrollment and takes place at the workplace.

The primary types of SI products are whole life and term insurance. Whole life is sold in small face amounts and is primarily sold in the final expense and worksite settings. Term insurance offers a fixed or limited face amount found in the mortgage and financial institution market. The whole life and term products are typically fully guaranteed and have limited underwriting. The remainder of this article will explore SI from a senior market perspective relative to whole life insurance. The discussion items still apply to all SI.

Product design is very important. As mentioned earlier, a simple, guaranteed "no frills" product is required. Substantial pricing work will be involved, starting with market research.

Market research goes beyond identifying the end consumer. In addition, research should consider how and who will do the selling plus the competitors offering similar products. Once you have an understanding of your market, establishing assumptions is not easy, specifically mortality. Although there is general mortality information available for SI types of products, it gets sketchy when you start looking at older ages. Lapses, premiums, cash values, benefit and rider considerations all require a good understanding of your market.

Packaging is an important consideration as part of the product design. The goal is to keep it simple and provide everything necessary to increase the odds of a smooth transition from application to policy delivery. The client piece—application, disclosures and any additional forms—must be packaged such that accuracy and completeness is maximized.

The application should be brief and straightforward. The application must be thorough enough to accomplish your anticipated mortality results and minimize selection, yet short enough to keep the process simplified. This is easier said than done. The number of questions is not as important as the content. It is more simplified and effective to have five unique ailments covered in

five separate questions than five unique ailments covered in one question. Reader comprehension is essential to accurate answers. Questions should be yes/no, not open-ended. Open-ended questions lead to open-ended answers that can lead to extended underwriting. One page (front and back) is a good rule of thumb for the application length. The result is an application that is accept/reject and can be rapidly reviewed by an underwriter, if necessary.

With a solid accept/reject application, any underwriting tools are fair game as long as they are fast in nature. A Medical Information Bureau (MIB) query and MVR are good examples of fast underwriting tools. Another would be a "drug knock-out list." An APS is a slow underwriting tool and should be avoided. One tool that has become more popular in certain SI markets is the point of sale interview (POSI). The application questions are reviewed with the prospective insured for completeness during a phone interview. In addition, the interviewer confirms with the agent the basic customer information and the completeness of the application information. The entire interview takes only five to 10 minutes and is recorded. The process provides confidence in the application and can streamline the underwriting process. The recording can be valuable to both the underwriter and the claims person if questions arise regarding the taking of the application. Recordings are available "same day as requested" which compliments the streamlined process.

The biggest benefit and one of the primary objectives of SI is fast turnaround. To be successful, the policy needs to get into the policyholder's hands as quickly as possible. Otherwise, you are defeating the purpose of a simple product with minimal underwriting. Sixty percent of our SI whole life policies are issued the same day we receive them. For the first quarter of 2005, we are averaging under two days turnaround on all simplified business.

Packaging is an important consideration as part of the product design. The goal is to keep it simple....

The learning never ends with SI. Once a product is in place you have to monitor your results and the market. Items worth monitoring include mortality, contested and denied death claims, causes of deaths, lapses, policies not taken or never issued, NSF check problems tied to the initial premium payment and the monthly electronic fund drafting after issue, average face amounts, average premium amounts and distribution results.

At the same time, you need to monitor the competition. A shift in product designs, underwriting classifications or application questions could leave your company vulnerable to anti-selection. When the market dramatically changes, you may start all over again but you'll have accumulated a wealth of knowledge to help you make better decisions on the redesign. A word of caution: don't try to introduce too many changes all at once. Change is tough on everyone. The collective changes may look very positive but, when introduced, the changes may throw your agents for a loop, possibly decreasing your business.

SI is an interesting concept. As the industry continues to look for ways to increase market penetration and to speed up the delivery of life insurance policies, the concept and creativity of SI will continue to grow. ●

Michael Agan, ASA, MAAA, is product development manager at Motorists Life Insurance Company in Columbus, Ohio. He can be reached at mike.agan@motoristsgroup.com.

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Special note: Meet the authors at a book signing at the Spring Meeting in New Orleans June 15-17, 2005!

Highlights of the March 2005 NAIC Life and Health Actuarial Task Force Meeting

by Donald P. Maves

I attended the LHATF Spring Meeting held Mar. 10-11, 2005 in Salt Lake City, at which LHATF discussed the issues described below.

Nonforfeiture for Individual Deferred Annuities

LHATF, working from a redraft of the model regulation as a result of its Feb. 22 conference call, discussed three items: (1)LHATF made no changes to the value-trigger method, (2)the American Academy of Actuaries (AAA) is reviewing the prospective test and will have comments at the next meeting and (3)finally, LHATF members appeared reluctant to bifurcate contracts with both EIA and other benefits, and thus the model regulation will be revised to eliminate such bifurcation.

A revised draft will be exposed for comments.

Variable Annuity Reserves Actuarial Guideline

The Academy Work Group made the following significant changes to the VACARVM draft:

- Guidelines for the recognition of revenue sharing are more detailed.
- Standard Scenario is modified as recommended by NY.
- Alternative Method mortality must be a "prudent best estimate."
- Calibration criteria have been modified and strengthened to address left-tail risk.
- New Appendix 10 gives guidance for setting prudent best estimate mortality.

The WG observed that, in testing, the Standard Scenario seriatim result still produces greater reserves than stochastically generated reserves in the aggregate. LHATF was not swayed by the argument. LHATF will expose the latest AAA draft.

Report From AAA Nonforfeiture Improvement Work Group

This group issued a high-level report looking for feedback from LHATF. The report emphasizes the need for flexibility of product design. Some of the designs under consideration include permanent and term products with no cash values, non-smooth cash values, periodic cash value resets, multi-line products, multi-generational products, market-value adjusted products and life cycle insurance.

The workgroup asked for specific feedback on scope, the concept of a purely retrospective approach, the independence of cash versus "continuing" benefits and the desirable regulatory parameters on the management of non-guaranteed elements.

Report From AAA SVL 2 Work Group

The work group spent some time discussing the Canadian approach to "principle-based" valuation opinions. Canada uses "worst plausible" scenarios, requires peer review and has a method for resolving differences of opinion between the opining actuary and the reviewer. In Canada every item on the balance sheet is open to choice by the actuary.

LHATF members expressed interest in learning more details about the Canadian process, including the possibility of having a Canadian expert discuss the approach at its next meeting. In the interim, LHATF will schedule a conference call to give feedback to the work group on its report.

Referral on Accounting for Life Reinsurance Credits

LHATF voted to send its Mar. 10 draft response to the Statutory Accounting Principles Work Group. The response disallows reinsurance reserve credit for the type of arrangement under consideration because it is neither YRT nor coinsurance. It is a form of YRT, but with guaranteed premiums such that XXX reserves would be required.

New Valuation and Nonforfeiture Mortality Table for Preneed Life Insurance

Some companies in this market believe that the 2001 CSO Table is inadequate for this type of business. An SOA task force has been formed and is about to send out a request for data. The task force has already received enough informal

commitments from companies that it believes that the data will have total credibility. Companies want this new table for tax reserve and section 7702 purposes, also.

GRET Factors for 2006

An SOA committee will begin its analysis of current industry expenses shortly, for use with the Life Insurance Illustration Regulation in 2006. The GRET factors for 2005 were not changed because the analysis produced wide fluctuations from the prior year.

Updates on AG ABC and Deletions/Amendments to Various NAIC Models

These issues were postponed until future conference calls. ABC is a proposed guideline for the projection of guaranteed nonforfeiture benefits under CARVM.

Other Matters

LHATF discussed its self-imposed "four-week rule," in which material not submitted at least four weeks prior to a meeting might not be discussed at the meeting. LHATF agreed to hold no conference calls in that four-week period

Report of the A&H Work Group

The working group reported the following items from its meeting:

- The WG completed the Long-Term Care Model Regulation and the LTC Rating Guidance Manual. Both will now be sent to the Senior Issues Task Force for approval. The group has just begun to study statutory reserves for LTC, and expects to get input from AAA.
- Alaska proposed changes to the medicare supplement refund formula, third-year loss ratio requirements and experience reports, but this will require changes to federal laws.
- Premium deficiency reserves have been contentious, with unfocused discussion up to now. The working group has identified key issues for continuing discussion.
- Alternatives for individual medical rate regulation will be discussed on a conference call in April.
- The work group incorporated recommendations (see Jan. LHATF mailing) to the *Medicare Supplement Guidance Manual*. The revised manual now goes to the Senior Issues Task Force.

AAA UL Work Group Update

This work group is developing a long-term, principles-based approach to reserves. As such, the scope is much narrower than SVL 2 (see above), which is studying high-level issues of capital and corporate governance. This work group's role is not to get directly involved in the AG XXXVIII controversy.

The work group has started with UL with secondary guarantees, term insurance and VUL, and then will extend the approach to all life insurance. It will have a draft of basic principles ready for discussion at LHATF's June meeting.

The UL Work Group is working with both the ACLI and AAA to consider the effects of federal tax requirements on the final product.

Issues Relative to Actuarial Guideline XXXVIII

This was expected to be a long and contentious session. However, at the end of the day LHATF and industry managed to craft a framework for a potential solution. Much work still needs to be done.

The short-term proposed solution renumbers the current Item 8 of the Guideline as 8A and makes it effective from the beginning until some future cutoff date. It would then add 8B, which would be similar to the exposed revisions from December and would be effective after the cutoff date.

A lengthy debate of a July 1, 2005 cutoff date versus a Jan. 1, 2006 date ensued, but in the end LHATF agreed on the latter. Thus, new section 8B will apply only to issues of 2006 and later.

LHATF then discussed the (A) Committee's request for a long-term solution. An industry coalition had submitted an asset adequacy based revision to AG XXXVIII. It keeps the current formulaic method, defines a "Reserve Adequacy Testing Method," allows for a safe harbor (as yet not explicitly defined) and applies only to policies subject to Item 8 of the current guideline.

This document, although not exposed, will be discussed in a future conference call. LHATF members seemed lukewarm toward the proposal, but not hostile to it. They did not rule out other as yet undefined approaches.

The next LHATF meeting is scheduled for Boston in June 2005. LHATF will have conference calls on specific issues in the interim. ●

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Life Valuation and Nonforfeiture Maximum Rates May Drop in 2006!

by Bradley D. Leonard

Editor's Note: This article was written in late March. By the time you read this, it will be late June 2005 and the 2006 valuation and nonforfeiture rates should be known for certain, since they are based on Moody's rates through the end of June.

Background

The maximum rates permitted for valuation and nonforfeiture have remained steady for life insurance since 1995. For long-term guarantees, it is routine to value life contracts at 4.5 percent and establish cash values for non-interest-sensitive contracts or other traditional guarantees at 5.75 percent. Your entire portfolio of traditional life products is probably based on this assumption. Although annuities are not covered in this article, the approach is similar but varies among the different classifications of annuities.

2006 Problem

With falling interest rates, it is extremely likely that starting January 2006, you will need to value life products at 4.0 percent (instead of 4.5 percent) and, after a one year grace period, will be required to refile all life policies to reflect guaranteed cash values at 5.0 percent (instead of 5.75 percent). This may be required by formulae contained in the valuation and nonforfeiture laws, computed using reference rates ending June of the year prior to being effective. So, the rate is determined by June 2005 for an effective date of January 2006. Shown below (Table 1)are current and alternative rates required as of the end of February 2005.

See details of the calculation later in this article. You can follow the monthly Moody's trend by checking out the last two months rates at *www.naic.org.*

The Impact

If these maximum rates reduce, all new business in 2006 will require higher statutory reserves based on 4.0 percent. Higher cash values are not required until January 2007 to give time for refiling. In the meantime, if rates go back up in 2007, higher cash value may not be required. Thus, at a minimum, valuation systems will have to recognize lower rates and profitability will need to be tested on all affected plans, with possible necessary product changes. This will definitely impact profitability, sometimes dramatically. If cash values increase, policy forms will need to be refilled and further profit analysis may require other changes. This, in turn, may require new plan codes, marketing material, agent compensation forms, applications, illustration changes, etc.

Strategies if Valuation Rate Drops to 4.0 percent.

The most obvious strategy is to consider all this in conjunction with your 2001 CSO strategies, both for profit offsets in many cases, as well as the administrative advantage of revising plans for both needs simultaneously. However, given that cash value increases are deferred until 2007 (and may be reversed), it might be prudent to either ignore higher cash value for 2006 issues or file two versions in order to be prepared either way in 2007. This all depends on other reasons for filings now and later.

If rates do stay lower, profitability testing and some design or other tweaks may be in order. Simple changes, not involving filing, include interest-credited rates, commissions, tighter underwriting (if otherwise justified), dividend formula and adjustment of other non-guaranteed elements. Premium changes only require minimal filing.

Perhaps there might be a way to design products that utilize guarantee durations of 20 years or less, such as a rider to a base life product. This would lower reserve requirements for situations where reducing face amount is acceptable. A limited term rider could even have an option of a monthly income benefit to better address both immediate and income needs at death, with pricing advantages over traditional term policies that renew beyond 20 years.

Whether due to 2001 CSO changes or accommodating 4 percent valuation rates, this may be an opportunity to fix or address any changes that

Table 1

Guarantee Duration	2004 maximum valuation rate	Moody's 12 mo average must exceed – to avoid drop	Moody's– July 2004 thru February 2005	Moody's– March thru June 2005 needed to avoid drop	2005 valuation rate based on Moodys = 5.89%	2007 max non-forfeiture rate if 2006 drops
More than 20 years	4.5%	6.22%	5.89%	6.2892%	4.00%	5.00%
More than 10, less than 20 yrs	4.75%	6.06%	5.89%	6.41%	4.25%	5.25%
More than 20 years	5.00%	6.26%	5.89%	7.01%	4.50%	5.75%

could work to your advantage. Do you have a product that is outdated, either from a marketing or pricing perspective? Perhaps you might even have a traditional life product on the shelf that has been uncompetitive and has enough margins to absorb the lower valuation rate, changing its competitive position in a post-2005 world. Maybe you could reduce or expand your product offerings, expand or contract distributions systems, switch emphasis to other lines of business, etc.

Determination of Maximum Valuation Rates

The maximum statutory valuation rate varies by the guarantee duration, defined as follows:

> For life insurance, the guarantee duration is the maximum number of years the life insurance can remain in force on a basis guaranteed in the policy or under options to convert to plans of life insurance with premium rates or nonforfeiture values or both which are guaranteed in the original policy (Standard Valuation of Law)

The basic formula below produces a value of I which is rounded to the nearer 0.25 percent. If this resulting rate is at least 0.50 percent more or less than the prior year's rate, then it becomes the new rate; otherwise, the rate remains unchanged. If the calculation of I is exactly between two rounded rates, rounding is taken to the lower 0.25 percent.

There is one basic formula, which produces different results by guarantee duration due to the "weighting factors" contained in the formula.

$$I = .03 + W (R1 - .03) + W/2 (R2 - .09),$$

where R is the reference interest rate, defined as the lesser of the 12-month or 36-month average for the period ending on June 30, 2005, of Moodys Corporate Bond Yield Average—*Monthly Average Corporates*, as published by Moody's Investors Service, Inc. There is an exception permitted to have the period end on Dec. 31, with approval of the Director.

R1 is the lesser of R and .09.

R2 is the greater of R and .09.

W varies by guarantee duration as follows:

Guarantee Duration	Weighting Factor (W)
10 years or less	.50
More than 10 and not over 20	.45
More than 20 years	.35

The maximum nonforfeiture interest rate equals 125 percent of the calendar year statutory valuation interest rate as defined in the Standard Valuation Law, rounded to the nearest 0.25 percent. If falling exactly between two such percents, the rate is rounded to the higher 0.25 percent. At the option of the insurer, the rate used can be as high as the maximum rate in the immediately preceding calendar year. ●

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Letter to the Editor:

I enjoyed reading David Smith's article, "Gross Premium Reserve Mechanics." I'd like to bolster his presentation with two additional perspectives.

The first has to do with federal income tax. Historically, an application of the GPV concept usually has excluded the FIT from consideration. Since there are no "definition" police, the actuary needs to know when to include and exclude FIT. For a GAAP application, such as loss recognition, FIT is excluded. When a GPV is used to satisfy statutory regulatory asset adequacy testing, the FIT needs to be considered in drawing the final conclusion.

The second item has to do with assumptions. Generally, they should be the actuary's best estimate. A GPV done simultaneously for statutory and GAAP purposes should be done using the same set of assumptions.

Tom Herget, FSA

A Relatively Favorable Ruling from the IRS on Treatment of Term Riders

by Ed Robbins

The Internal Revenue Service recently released Revenue Ruling 2005-6. This ruling provides formal guidance on how to treat family term riders for purposes of the computational limit calculations in Internal Revenue Code (IRC) sections 7702 and 7702A (i.e., calculations of net single premiums, guideline single premiums, guideline level premiums and 7-pay premiums). The ruling also provides a relatively painless way to grandfather existing policies that may have been administered in a manner out of compliance with the IRS's newly published guidance. This is an issue over which the industry has been in a quandary for over a decade. The issue involves these two IRC Code sections in the following way:

- For purposes of section 7702 (Life Insurance Contract Defined), how do you calculate the increment to the computational limits attributable to family term riders? Do you use the actual charges reasonably expected to be imposed—as is required for Qualified Additional Benefits (QABs) so named in section 7702(f)(5)? Or, can a company use the mortality table applicable to the base policy in determining such increments? What if the rider is simply additional life insurance on the base policy's insured?
- For purposes of section 7702A (Modified Endowment Contract Defined), the same issues exist for the computation of the increment to the seven-pay premium attributable to a family term rider.

Especially for universal life contracts with term riders, this can often make a significant difference in the amount of monies that can be paid into a contract. Moreover, there has been the danger that the wrong historical company practice could put many existing policies out of compliance.

History of the Issue

The original section 7702 was placed in the IRC via the 1984 Tax Act. The issue of family term riders was not considered a problem until the 1988 Tax Act, when the computational limit for mortality and "other than mortality charges" for qualified additional benefit riders—read QABs for purposes of this article—was changed, from reflecting *guaranteed* charges to reflecting charges *reasonably expected to be actually paid*. However, mortality charges on the base contract were not subject to the same requirement. Notice 88-128, issued about that time, generally allowed mortality charges used in the calculations for the base contract to reflect 1980 CSO table mortality—effectively a "safe harbor" for base contract mortality charges.

The 1988 Tax Act, which created section 7702A, included in its legislative history, specifically the Senate Amendment, that "riders to contracts are considered part of the base insurance contract for purposes of the 7-pay test." Thus many of us felt that this was sufficient justification for using the 1980 CSO safe harbor for family term riders, including riders on the base insured, when calculating 7-pay premiums.

Several private rulings were issued in the mid-1990s, most notably Private Letter Rulings (PLRs) 9513015 and 9519023. Under both PLR 9513015 and 9519023, support was given for treatment of term riders as part of the base contract under section 7702A, i.e., for purposes of the 7-pay test, consistent with the above legislative history language. However, for purposes of section 7702 under both of these rulings, term insurance riders on the base insured were taken to be QABs, and thus not covered under the Notice 88-128 safe harbor. The mortality assumptions used in the calculation of the section 7702 computational limits

were accordingly limited to the charges actually expected to be imposed, i.e., a lesser amount than if the 1980 CSO safe harbor were available.

Subsequently, the IRS issued PLR 9741046, which distinguished term riders on the base insured that provided coverage to age 95 (or beyond) from those that provided coverage for a shorter period. For the former "lifelong" contracts, the IRS felt that it was appropriate to treat such riders as part of the base contract and accordingly subject to the mortality charge "safe harbor." Thus, only the shorter duration term riders remained subject to the more restrictive rule, and only for purposes of section 7702, not 7702A.

Meanwhile, many companies did not incorporate the provisions of the above PLRs in practice, as they disagreed with the conclusions of the PLRs based on what they felt were reasonable interpretations of the then current authoritative guidance. In particular, the provisions in section 7702 itself lacked clarity.

Only the provisions applicable to the cash value accumulation test specifically require that determinations with respect to QABs be made using the reasonable charges actually expected to be imposed (see section 7702(b)(2)(B)). A lack of similar specificity under the guideline premium test led many insurers to believe that the Notice 88-128 safe harbor could be used for family term riders, including short duration term riders on the base insured.

In calculating the rider increments to the computational limits under section 7702, they continued to use the 1980 CSO table mortality assumptions instead of the COI charges actually expected to be imposed. That response was not necessarily inappropriate, in as much as PLRs are private rulings. Private rulings, while they are indicative of the thinking of the IRS, are not to be taken as authoritative guidance. That said, this series of events has led to a significant amount of uncertainty given the substantial potential adverse consequences for violating the computational limits under section 7702.

Revenue Ruling 2005-6

This ruling holds that family term riders are QABs, for purposes of both sections 7702 and 7702A. It is not clear whether the IRS has changed its position that short duration term riders on the base insured can be treated as part of the base contract for Modified Edowment Contract (MEC) testing purposes. However, the ruling has provided a streamlined process for accommodating companies that have used the 1980 CSO safe harbor.

A policy's grandfathered status will be lost if a new family term rider is added, or there is an increase to an existing rider…

It provides for a closing agreement under which a company has until Feb. 7, 2006 to send an inventory of policies issued on or prior to April 7, 2005 on which it seeks to maintain the old, more generous safe harbor limit. Such inventoried policies will be "grandfathered" from the application of Revenue Ruling 2005-6 for their lifetime. Policies issued after April 7, 2005 must comply with the less generous limit.

There is a fee for filing that inventory. It is a sliding scale based on the number of policies submitted, and it maximizes at $50,000 (for over 10,000 policies). It appears to be well worth the expense in most cases. The ruling, however, does not specify whether the fee scale applies to each corporate entity or to an entire controlled group.

The ruling also contains guidance as to what actions can cause a policy to lose its grandfathering. A policy's grandfathered status will be lost if a new family term rider is added, or there is an increase to an existing rider and the policy owner did not possess a contractual right to such addition or increase prior to April 8, 2005.

On the whole, many practitioners feel that this is a favorable ruling, despite the adverse position the IRS took on the merits of the issues themselves. Grandfathering existing policies is far more preferable than having to change limits on existing policies. ●

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A New Look at Reinsurers and Term

by W. Howell Pugh

Direct writers have increasingly faced a "hardening" market for reinsurance on term and universal life with secondary guarantees.

While the dwindling number of reinsurers try to scramble to keep market share, they are also faced with trying to recoup what appears to be mis-pricing on mortality. At the same time the growing realization of future amounts of XXX reserves that reinsurers have already committed to is raising forecasts for fees on letters of credit above the levels that were used in original pricing.

This has created an unprecedented environment between direct writers and reinsurers. At the SOA meeting in October 2004, one speaker related reinsurer actions such as:

- Raising rates on existing treaties for new business,
- Audits of underwriting files with particular attention to exceptions of preferred criteria, and
- Increasing arbitration of claims.

Now, up the pressure. In December 2004, the NAIC was shocked—yes shocked—to learn that companies have avoided the AXXX reserves for UL by having very large guaranteed expense charges. The commissioners have called for an actuarial committee to create a valuation system that would move from a formula approach to a cash-flow testing methodology. The goal is to substitute a valuation system based on principles instead of being rule-based. The presumption is that a principle-derived calculation method would better provide adequate reserves without over-reserving. They gave the committee a six-month deadline. This move may or may not be long overdue, however it will not be accomplished in six months.

However, assume there is a counterproposal at the June meeting to "fix" AXXX by limiting guaranteed expense charges, for example, and this is accepted as a short-term compromise while the committee has more time to contemplate. The industry will now have new demands for capital to fund the XXX and AXXX reserves required by law.

Reinsurers have gained enormous market penetration (over 60 percent of new business face amount) by bundling their services into a convenient package called coinsurance. Presently reinsurers are trying to fulfill two roles in life insurance. They provide reinsurance to dampen mortality fluctuation of the direct writer and they provide capital to offset reserves that are above the level, that direct writers can economically afford. Since reinsurance has in large part gotten us into this mess, I thought I would explore how to use reinsurance to get us out of it.

Consider a switch from coinsurance to YRT.

1. Without repricing, the company must now deal with the extra reserves.
   a. If the company wishes to avoid using its own capital.
      i. The company can source its own capital through securitization, as did Genworth last year.
      ii. It can use an affiliate captive offshore reinsurer and do the capital management internally. The captive can retrocede the mortality risk to your reinsurer and hopefully recreate in a roundabout way the position of your current coinsurance.

   At present the first method is believed to be more costly than the second. I view this as the greatest opportunity for both direct writers and reinsurers. Reinsurers have the expertise and the ability to easily tap the capital market. They could start up a business of deliberately securitizing their exposure and, by bundling their blocks of business, retail it to their direct writers.
   b. The company uses its own capital. Until now, coinsurance provided the extra lift for a company's IRR results. I expect this to change in the future as reinsurers start to properly reflect the cost of LOC. Thus go ahead and include the true cost of YRT reinsurance. Raise the retention back to normal levels. It will probably help if the company is looking at profit margin as the profit measure since YRT cannot provide the IRR lift that co-insurance has up to now.

2. Reprice, but do this very carefully in today's hardened market. The advantage is that you might be able to get a jump on the companies that seem to be frozen into their current rate structure.
   a. 2001 CSO will help alleviate some of the XXX reserves.
   b. Move to a non-guaranteed premium structure. Make this more palatable to the field force by slightly increasing the compensation.
   c. If possible, introduce a premium scale that is reduced by dividends. It would not be possible to avoid the illustration regulation using this approach.

The direct company needs to be aware of the alternatives and monitor the environment. Be prepared for action the next time the reinsurer asks for a repricing of your existing reinsurance. ●

Smaller Insurance Company Sessions at the Annual Meeting

by W. Howell Pugh

The Society of Actuaries Annual Meeting will be held on Nov. 13-16, 2005 at the New York Hilton in New York. Below are the sessions that will be sponsored by the Smaller Insurance Company Section

On Monday, Nov. 14 at 2:00PM; a workshop is co-sponsored by the Risk Management Section on:

Avian Influenza: Is Your Company Prepared?

Moderator: Howell Pugh

Panel: David Ingram, Max Rudolph

- Since 2003, avian influenza has become rampant in Southeast Asia. Health experts warn that we are on the brink of a new influenza pandemic. Attendees share information and techniques for stress testing their company preparedness:
- First, on any significant mortality fluctuation, a smaller company has a greater chance of having unusually high claims than does a larger company (and a greater chance of missing it altogether). A small company should think through whether their retention limits are set appropriately to provide for something like a flu epidemic.
- Second, the flu epidemic could be a stress scenario that a small company could use to look at surplus adequacy and operational preparedness. The small company attendees learn about flu scenarios to help them form appropriate stress tests.
- Attendees can boost their knowledge by advance reading. Two excellent summaries are: World Health Organization, "Avian influenza: assessing the pandemic threat", can be downloaded at *http://www.who.int/csr/disease/influenza/WHO_CDS_2005_29/en/*.
- Max Rudolph, "Influenza Pandemics: Are we ready for the next one?" *Risk Management* newsletter, July 2004.

On Tuesday, Nov. 15 at 10:30AM; a buzz group session:

Products of Interest for Small Companies

Moderator: Terry Long

Panel: TBD

Share product ideas with peers working in small companies.
- Attendees break into small groups to discuss products of their choice. Facilitators lead the discussions while all group members have opportunities to contribute. Midway through this session, attendees have the opportunity to rotate to other discussions.
- Attendees have the chance to discuss problems and solutions with other small company actuaries and be better able to examine the tradeoffs of the products discussed.

This session is designed for attendees who have **moderate experience** with the subject.

On Tuesday at 2:30PM; a panel discussion cosponsored by the NonTraditional Marketing Section on:

Protecting A Niche Market

Moderator: TBD

Panel: TBD

Attendees learn how other small companies have built market niches that can center on a product, a distribution channel, a specialized service or other type of specialization.

During the session, attendees discover how to:
- Develop and utilize expertise to be the most efficient provider.
- Develop a reputation as a leader in the market.
- Develop empathy for the market so that you are the "go-to" company for the niche product or service.
- Use sole focus to innovate in the market.
- Protect innovation and niche with patents.

This session is designed for attendees who have moderate experience with the subject.

Finally on Wednesday, a continental breakfast and business meeting:

Smaller Insurance Company Section Breakfast

Chairperson: Terry Long

- Network with peers working in small companies.
- Attendees meet new officers of the section council.
- Attendees share ideas for planning section events during the next year.

This session is designed for attendees who have **no experience** with the subject.

This session is open to members of the Smaller Insurance Company Section only. There is no fee. Please plan to attend. ●

W. Howell Pugh, FSA, MAAA, is a consultant. He may be reached at howellp@comcast.net.

Notice 2004-61: Guidance on Mortality under IRC Section 7702

by John T. Adney and
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Last fall, the Internal Revenue Service (IRS) released Notice 2004-61, 2004-41 I.R.B. 596 (October 12, 2004), interpreting the reasonable mortality charge requirement applicable to life insurance contracts under Section 7702 of the Internal Revenue Code. This notice supplements, and may modify in certain respects, guidance that the IRS provided in 1988 through Notice 88-128.

The subject of Notice 2004-61 is Section 7702(c)(3)(B)(i), which sets out the mortality charge assumption that is permitted to be used in determining net single premiums and guideline premiums, under Section 7702. In particular, this Code provision states that such determinations must be based on "reasonable mortality charges which meet the requirements (if any) prescribed in regulations and which (except as provided in regulations) do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in Section 807(d)(5)) as of the time the contract is issued." This same mortality charge requirement applies for purposes of the 7-pay test under section 7702A, which defines a modified endowment contract for federal tax purposes. The impetus for the issuance of Notice 2004-61 was that the 2001 Commissioners' Standard Ordinary (CSO) mortality tables became the prevailing tables within the meaning of Section 807(d)(5) during 2004, and thus guidance on the transition from the previously applicable 1980 CSO tables to the new 2001 CSO tables was needed.

Safe Harbors

Notice 2004-61 provides three safe harbors that will apply pending the publication of additional guidance. The first safe harbor provides that the interim rules described in Notice 88-128 remain in effect "except as otherwise modified by this notice." (Notice 88-128 included, for example, a safe harbor allowing use of mortality charges that do not exceed 100 percent of the applicable mortality charges set forth in the 1980 CSO tables.) The second safe harbor provides that, for a life insurance contract issued before January 1, 2009 in a state that permits or requires use of the 1980 CSO tables at the time the contract is issued, use of mortality charges in calculations under Section 7702 will satisfy the requirements of Section 7702(c)(3)(B)(i) if they do not exceed the lesser of (a) 100 percent of the charges set forth in the 1980 CSO tables and (b) the mortality charges specified in the contract at issuance. The third safe harbor provides that, for a life insurance contract issued after December 31, 2008, or on or before that date in a state that permits or requires use of the 2001 CSO tables at the time a contract is issued, use of mortality charges in calculations under Section 7702 will satisfy the requirements of Section 7702(c)(3)(B)(i) if they do not exceed the lesser of (a) 100 percent of the charges set forth in the 2001 CSO tables and (b) the mortality charges specified in the contract at issuance.

Gender and Smoker Variations to CSO Tables

In addition to the above safe harbors, Notice 2004-61 provides guidance regarding gender and smoker-based variations of the 1980 CSO and 2001 CSO tables. In particular, if a state permits minimum nonforfeiture values for all contracts issued under a plan of insurance to be determined using 1980 or 2001 CSO Gender-Blended Mortality tables, then the applicable charges of such tables are treated as reasonable mortality charges for female insureds, provided the same tables are used to determine mortality charges for male insureds. Similarly, if a state permits minimum nonforfeiture values for all contracts issued under a plan of insurance to be determined using 1980 or 2001 CSO Smoker and Nonsmoker Mortality tables, then the applicable charges of such tables are treated as reasonable mortality charges for smoker insureds

provided nonsmoker tables are used to determine nonsmoker mortality charges. These "anti-whipsaw" rules are similar to those provided in proposed regulations issued in 1991 but never finalized.

Rules Addressing Changes to Contracts

The last subject addressed by Notice 2004-61 regards identification of the issue date of a contract and the circumstances when a change to the contract — i.e., a so-called material change — will cause it to be considered as newly issued for purposes of applying the notice. In this respect, Notice 2004-61 generally states that the date a contract is considered issued will be determined according to the standards in place at the time of the original effective date of Section 7702, which is also based on the "issue date" of a contract. The Notice elaborates on this in several respects. First, it observes as an example that contracts received in exchange for existing contracts are to be considered new contracts issued on the date of the exchange. The Notice then states as a general rule that a change in an existing contract will not be considered to result in an exchange if the terms of the resulting contract (that is, the amount and pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract and mortality and expense charges) are the same as the terms of the contract prior to the change. These statements have counterparts in Notice 88-128.

Going beyond the 1988 notice, at the urging of the life insurance industry, Notice 2004-61 provides that a contract satisfying one of the 1980 CSO table safe harbors need not begin using the 2001 CSO tables upon a change in benefits if (a) the change, modification or exercise of a right to modify, add or delete benefits is pursuant to the terms of the contract, (b) the state in which the contract is issued does not require use of 2001 CSO for such contract under its standard valuation and minimum nonforfeiture laws and (c) the contract continues upon the same policy form or blank. Somewhat departing from the industry's request, Notice 2004-61 further states that the changes, modifications or exercises of contractual provisions referred to include addition or removal of a rider, an increase or decrease in death benefit (if the change is not underwritten), and a change from an option 1 to option 2 contract or vice versa.

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Questions that Have Been Raised

Many of the rules provided by Notice 2004-61 have been favorably received by insurers, particularly those addressing when newly issued contracts would need to begin using the 2001 CSO tables under the safe harbors. A number of questions/issues have arisen, however, with respect to the notice.

Relationship between first and second safe harbors.

One issue regards the effect, if any, of Notice 2004-61 on the safe harbor rules contained in Notice 88-128. As noted above, Notice 2004-61 states, as its first safe harbor, that the interim rules of Notice 88-128 remain in effect, except as otherwise modified by Notice 2004-61. At the same time, the second safe harbor of Notice 2004-61 sets forth requirements that appear largely the same as those of the 1980 CSO table safe harbor of Notice 88-128, but it adds a requirement that mortality charges reflected under section 7702 cannot exceed the mortality charges guaranteed under a contract. Given that this additional requirement was not part of the Notice 88-128 safe harbor, questions have been raised regarding whether this additional requirement constitutes a modification, potentially retroactive, to the Notice 88-128 safe harbor. In other words, when the first safe harbor of Notice 2004-61 states that the rules of Notice 88-128 remain in effect "except as otherwise modified" by Notice 2004-61, did the IRS intend for the requirements of the second safe harbor to constitute such a modification, so that the 1980 CSO table safe harbor of Notice 88-128 would effectively be replaced by the second safe harbor of Notice 2004-61? On its face, Notice 2004-61 does not do this. The description of the second safe harbor in Notice 2004-61 does not in any fashion indicate that it has any relevance to the first safe harbor of this notice. In addition, section 5.02 of Notice 2004-61 refers to the first and second safe harbors as separate safe harbors (which of course they are); it would be odd to do this if the second safe harbor was intended in

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Given the questions that have been raised with respect to Notice 2004-61 and the topics still unaddressed, it seems likely that this notice is just first round by the IRS in clarifying some of the open questions presented by the mortality charge requirement of Section 7702.

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some manner to replace the first safe harbor. The continuing applicability of Notice 88-128 more generally is shown by the fact that Notice 2004-61 neither includes a safe harbor pertaining to life insurance contracts, that have relied upon the 1958 CSO safe harbor of the earlier notice, nor modifies this safe harbor, in any respect.

Given that the first and second safe harbors of Notice 2004-61 are, in fact, separate, one may reasonably ask why there is any confusion in the first instance, but there are several reasons why questions have been raised. One such reason is that it is not immediately clear from Notice 2004-61 what modifications have been made to the safe harbor rules of Notice 88-128. As noted above, the first safe harbor of Notice 2004-61 states that the rules of Notice 88-128 continue to apply except as otherwise modified by Notice 2004-61, and, by this statement it seems clear that some such modifications must have been made. However, Notice 2004-61 does not contain any direct statements identifying what such modifications are, nor is any effective date rule for application of such modifications set forth in Notice 2004-61. One possibility in this regard is that the guidance in Notice 2004-61 relating to smoker and gender table variations may represent such modifications. In other words, under the first safe harbor, the rules of Notice 88-128, including allowance of 100 percent of 1980, continues as a valid safe harbor except as modified by the discussion relating to such table variations, which generally allow greater flexibility.

A second reason for confusion regarding the relationship of the first and second safe harbors of Notice 2004-61 is that, if the first safe harbor of Notice 2004-61 continues, the 1980 CSO table safe harbor of Notice 88-128, e.g., as modified by the discussion in Notice 2004-61 regarding gender and smoker table variations, then it becomes somewhat unclear why the second safe harbor of Notice 2004-61 was needed, since it mirrors the requirements of the Notice 88-128 safe harbor, but also adds a new requirement. Since the first and second safe harbors of Notice 2004-61 are largely identical, apart from the additional requirement imposed by the second safe harbor, seemingly no one should ever need to rely on the second safe harbor since they may simply rely on the first safe harbor without concern about the additional requirement imposed by the second safe harbor. If this is so, then one must ask why the IRS felt the need to include the second safe harbor.

The answer may be that the IRS may contemplate that an effective date rule may ultimately be made applicable to the first safe harbor so that it would not be available for newly issued contracts after some future date. In this regard, Notice 88-128 states that its interim safe harbor, allowing use of the 1980 CSO tables, applies to contracts that are issued on or before the date 90 days after the issuance of temporary regulations addressing reasonable mortality charges under section 7702. Notice 2004-61 does not constitute a temporary regulation; however, it may be prefatory to the issuance of such guidance, which may set forth an effective date after which the first safe harbor may no longer be available in its present form. (Some have asked whether the October 12, 2004 publication date of Notice 2004-61 in some manner sunsets the rules of Notice 88-128. This is unclear, although it is perhaps telling that Section 6 of Notice 2004-61, titled “Effect Upon Other Publications,” states merely that “This notice supplements Notice 88-128.”) Another possible explanation for the presence of both the first and second safe harbors of Notice 2004-61 may be that, while the second safe harbor may seem unnecessary given the first, there may be some differences that nonetheless exist between them that made inclusion of the second appropriate.

Underwritten Increases in Benefits

As discussed above, Notice 2004-61 contains a discussion regarding changes to a contract that will cause it to be treated as newly issued for purposes of applying the notice. In this regard, Notice 2004-61 states that, if certain requirements are satisfied, then a change, modification or exercise of a right to modify, add or delete benefits pursuant to the terms of a contract will not cause such contract to be treated as newly issued. The notice then goes on to list some examples, stating that the changes, modifications or exercises of

contractual provisions referred to include addition or removal of a rider, an increase or decrease in death benefit (if the change is not underwritten), and a change from an option 1 to option 2 contract or vice versa. Some questions have been made about the purpose of the parenthetical, and particularly whether it implicitly stands for the proposition that an underwritten change in benefits does cause a contract to be treated as newly issued.

At present, the precise import of Notice 2004-61 for underwritten benefit increases is unclear, but it is important to note that the sentence in question that contains the parenthetical about nonunderwritten increases is simply a list of examples of types of changes that do not cause a contract to be treated as newly issued. The sentence, by using the word "include," is not purporting to set forth a comprehensive list. Also, if the IRS had intended that all underwritten increases would cause a contract to be treated as newly issued, the IRS could have added a sentence to this effect, and one might expect that it would have done so, given that underwritten increases are one of the most common kinds of changes contracts experience and the proper treatment of such increases has been a source of much discussion since the enactment of the present version of Section 7702(c)(3)(B)(i) in 1988. At a conference, sponsored by the Society of Actuaries last fall, representatives of the IRS made informal comments that are consistent with the above analysis, i.e., that the sentence containing the reference to non-underwritten increases is illustrative, rather than comprehensive, and that there was no intention to imply that all underwritten increases would cause a contract to be treated as newly issued. At the same time, these representatives observed that some underwritten increases may be so material relative to the pre-change contract that they would result in a deemed new issuance of the contract. No clear line exists at present to distinguish underwritten increases that have the one treatment versus the other, although it seems fair to say that underwritten increases that are in no way extraordinary relative to those commonly made by owners of life insurance policies, probably should not cause a contract to be treated as newly issued for purposes of applying Notice 2004-61.

Request for Comments and Future Actions

Notice 2004-61 requested comments from taxpayers, which were due on January 10, 2005, regarding guidance needed to address issues not specifically addressed by this notice or Notice 88-128, including issues addressed by section 1.7702-1 of the proposed regulations issued in 1991. The American Council of Life Insurers, the principal life insurance industry trade association, has submitted comments and requested guidance with respect to, among other things, the treatment of life insurance contracts insuring multiple lives and substandard risks and regarding how to account for the fact that the 2001 CSO tables have extended the terminal age to 121, whereas section 7702 requires the assumption of a maturity date no earlier than the day on which the insured attains age 95 and no later than the day on which the insured attains age 100.

Given the questions that have been raised with respect to Notice 2004-61 and the topics still unaddressed, it seems likely that this notice is just the first round by the IRS in clarifying some of the open questions presented by the mortality charge requirement of Section 7702. ●

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