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Changes in the Valuation Interest Rate

by Terry M. Long and Donna K. Ferguson

Bob Dylan's quote "the times they are a changing" has more relevance today than ever before in the insurance industry. Among the multitude of issues your company must deal with every day, add more if you market individual life, disability income or long-term care insurance. Two important changes are about to affect the reserves and nonforfeiture values your company holds for newly issued life insurance policies:

- the reduction in the life valuation interest rates; and
- the adoption of the 2001 CSO Table.

What does this mean for your company?

First and foremost, these changes will significantly add to your to-do list in the near future. At a minimum, reductions in the life valuation interest rates will require changes in reserves for policies issued in 2006. The change in mortality basis will affect all life insurance policies issued after 2008, but for practical reasons, might require more urgent action. This article should serve as a heads up on these issues so your company can create an action plan now.

Life Valuation Interest Rates

For 2006 new business, the long life valuation interest rate will decline from the historical 4.50 percent to 4.00 percent. Unlike the 2001 CSO Mortality Table that needed to be approved by individual states and permitted a transition period, this change will automatically take effect Jan. 1, 2006 as required by the Standard Valuation Law.

The decrease in the maximum life valuation interest rates means reserves required to be held for a product based on a 4.50 percent interest rate must be recalculated for policies issued in 2006. Note that the change in the maximum valuation interest rate also caused a change in the maximum nonforfeiture interest rate. The reduced maximum nonforfeiture interest rate of 5.00 percent (125 percent of the maximum statutory valuation rate rounded to the nearest 0.25 percent) will be mandatory in 2007. That is, there is a one-year grace period for nonforfeiture interest rate changes—the new interest rate is optional for 2006 but mandatory for 2007. Thus, nonforfeiture values must also be recomputed by the end of 2006. These rate decreases could impact the profitability of your product.

However, simply adjusting reserve factors and nonforfeiture values may not be adequate. The following issues may have a material impact on the profitability of products based on a 4.50 percent valuation interest rate:

- **Basic Reserves:** Increased basic reserves due to lower valuation interest rates could result in increased surplus strain and lower rates of return for products.
- **Deficiency Reserves:** Many life products have guaranteed gross premiums set equal to, or slightly greater than, the 4.50 percent valuation net premiums. Since valuation net premiums for these products will now increase, such gross premiums will now be less than the valuation net premiums. This could result in

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> unexpected increases in deficiency reserves if the gross premiums are not increased. The deficiency reserves, which can be sizeable, tie up surplus and decrease profitability.

As an example of the relative magnitude of the increases, we did testing for one client, which indicated that basic reserves would increase approximately 6.5 percent. Deficiency reserves, however, will increase more than 800 percent if the gross premiums are not increased!

2001 CSO Table

The 2001 CSO Table has now been adopted for use in almost all states. While a number of companies have already developed and introduced products based on the new mortality table, other companies were waiting to introduce 2001 CSO products. The reduction in the maximum valuation interest rate is causing a number of these companies to reconsider their decision. Rather than changing their products once for the valuation and nonforfeiture interest rate changes, and then again two or three years later to recognize 2001 CSO mortality, many companies are coupling the reduction in interest rates with the introduction of the 2001 CSO mortality table. If these issues are addressed simultaneously, a company will experience savings in filing, administrative, software and pricing. As an additional bonus, since the 2001 CSO Table reflects improved mortality, products priced on the new table will generally be more competitive. However, depending on product design there might still be reasons to delay the implementation of the 2001 CSO Table.

Company Options

There are several ways a company can deal with these issues, including:

- Simply holding higher reserves in 2006, and postponing premium and nonforfeiture changes until 2007; delay 2001 CSO adoption until 2007 or later.

- Filing the same product design with the necessary reserve and gross premium changes, but not changing the nonforfeiture values (and possibly gross premiums again) until 2007; delaying 2001 CSO adoption until 2007 or later.

- Filing the same product design with the necessary reserve, nonforfeiture value and gross premium changes in 2006; delay 2001 CSO adoption until 2007 or later.

- Restructuring and introducing a new product incorporating the valuation interest rate, nonforfeiture interest rate, 2001 CSO mortality and gross premium changes as soon as possible.

As an additional bonus, since the 2001 CSO Table improved mortality, products priced on the new table will generally be more competitive.

The first option, holding higher reserves in 2006 and postponing other changes until 2007 or later, has the benefit of being technically easy and not very time consuming. However, as a result, companies choosing this option could be holding much higher reserves than necessary.

If a company is comfortable with its current product portfolio, it can take the approach of using the same basic policy design with an increase in premiums and reserves, with the option to either maintain current nonforfeiture values and dividends or compute updated nonforfeiture values and dividends. This will still require a considerable effort to generate new reserve, nonforfeiture and dividend values. However, keeping the same product portfolio means the distributors do not have to make adjustments. Additionally, if these products performed well in the past they should continue to perform well in the desired target markets.

Some companies may decide that now is the time to redesign their portfolio of products. To restructure an entire product portfolio requires an enormous amount of time and energy, not only for actuaries but also from a host of company-wide resources such as marketing, underwriting, systems and so on.

Planning for These Changes

These changes represent some major hurdles that lie just ahead. Companies should address these issues today, as time is of the essence—2006 is quickly approaching. Changes to administrative, valuation and illustration systems will require efforts by marketing, actuarial and IT departments. Legal and compliance divisions will also be busy filing new and updated products.

Companies need to consider the various options available. Although many companies have already begun to incorporate the lower valuation interest rates and the 2001 CSO Table, that choice may not be the best choice for every company. Each company must analyze its portfolio and individual circumstances to determine the best action plan. Whether in-house or outside resources are utilized, making these decisions and implementing the changes will require much expertise and time. However, with proper planning a company can successfully handle these issues. ●

On the cover

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