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XXX Wreaks Havoc in Term Market

by James N. Van Elsen

The various states continue to move quickly to adopt the XXX Regulation (Valuation of Life Insurance Policies Model Regulation). At last count, 35 states plus the District of Columbia have adopted the regulation. Another 9 states appear to be moving to adopt the regulation soon. By the beginning of 2001, we could have almost uniform applicability of the reserving regulation.

While the industry's goal of uniform adoption of the regulation is so near, it is apparent that uniform interpretation of the regulation may not be attainable. Some of the "creative" interpretations of the regulation were discussed at the September meeting of the NAIC's Life & Health Actuarial Task Force (LHATF) in Dallas. The task force is considering whether an actuarial guideline is necessary to clarify the regulation. They are also considering how the regulators should comment on the proposed Actuarial Standard of Practice relative to the XXX regulation.

The following product designs have been cited as possible abuses of the regulation:

1. Universal life products with "shadow" accounts. These accounts are separate from the normal account value used to determine cash surrender values. Premiums are credited to the account in the same manner. As long as the "shadow" account has a positive balance, the policy will remain in force. Guarantees may be significantly more generous than that used for the account value. It is possible to calculate level premiums of any duration that would guarantee that the policy remain in force. How these premiums are used for XXX reserves is debatable. One interpretation results in long-term premium guarantees with reserves very similar to those carried by companies prior to XXX.
2. "Non-guaranteed" guarantees. A company may guarantee premiums on term insurance for only a short period, say five years. Premiums are projected, however, to remain level for 20 years. The company may provide another guarantee that they cannot increase the premiums unless interest rates fall below 3%. Several permutations of this are possible. Perhaps inflation has to go above 12%. Maybe the Cubs have to win the World Series. Are these premiums considered guarantees for XXX purposes?
3. Guaranteed dividends. A company guarantees a relatively high schedule of premiums. In addition, it guarantees that dividends will be payable that reduce the "net premium" to a competitive schedule of premiums. Which schedule of premiums is used for XXX purposes?
4. Guaranteed refunds. The current schedule of premiums is not guaranteed. The company guarantees, however, that if premiums increase, a refund will be given equal to the premium in excess of the current schedule. What schedule of premiums is used for XXX purposes?
5. Re-entry. Renewal premiums are not guaranteed. Re-entry premiums are guaranteed. To qualify for re-entry, new evidence of insurability must be provided. What if this new evidence is very easy to provide? For example, maybe you answer one question that is simply: "Are you terminally ill?" Are the re-entry premiums used in the XXX reserves?
6. Property & casualty insurance. A life insurance company issues a policy with the current premiums not guaranteed. The policy is issued with a contract from an affiliated property & casualty insurer, which guarantees to pay the extra premium if the life insurance company should ever increase the premiums. What reserves are held by the property & casualty insurance company?

To address their concerns about these new designs, LHATF is considering new actuarial guidelines to interpret the XXX regulation. The initial draft was developed by Robert Potter of the North Carolina Department of Insurance. Comments have already been received from several companies about the draft. The initial draft focused on the "shadow" account product design. The later letters have attempted to close the loopholes for other creative designs. No matter what is adopted, it will be difficult to anticipate all product twists that attempt to circumvent the intent of the regulation. Some regulators believe that no actuarial guideline is necessary, that what is need is for the regulators to enforce the regulation as it exists.

As this discussion continues, many companies are losing significant sales in the term market. Companies unwilling to experiment with some of the creative designs are losing market share to those that are willing. In addition, some companies are taking advantage of states that have not yet adopted the regulation. For example, a company domiciled in Michigan might continue to sell pre-XXX products. The company could file in Michigan, which has not yet adopted XXX, an annual statement that does not reflect XXX reserves.

Statements filed in states that have adopted XXX would reflect XXX reserves, but these are not generally made available to the public. The Michigan statement would be the one filed with the NAIC and the various rating agencies. This opportunity will diminish as the number of states which have not adopted XXX reduces.

The companies hardest hit by the shift in market share in the term market are the smaller companies. As a group of companies, they seem less willing to gamble on winning the debate with regulators on XXX reserves. They also do not have multiple company domiciles to be able to optimize the benefits of states not adopting XXX.

As the debate continues about the proper reserving for these new designs, these companies will continue to lose valuable market share.

The unitary reserving methodology was identified in the 1970's as a problem for renewable term reserves. The search for a solution continued until 1999 when XXX was adopted by the NAIC. Companies which had used the unitary reserves had their products "grandfathered." This was a necessary compromise because of the extremely large amount of business reserved using unitary reserves.

Hopefully, this new discussion of appropriate reserves will not take as long. Every day, smaller insurance companies are disappearing because they can no longer find markets to compete in. All that many of them need is a level playing field. Unless the regulators act soon, many smaller companies that rely on the term market will be irreparably harmed.

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