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AG CCC Causes Rethink on ROP Term

By George Hrischenko

Since the writing of this article, the NAIC adopted the proposed actuarial guideline AG CCC and it is now referred to as AG XLV.

Like so many aspects of the life insurance business, manufacturing return of premium (ROP) term just became more complicated. Actuarial Guideline CCC (AG CCC) is already effective for new policy forms and starting in 2010 affects all contracts. The guideline treats ROP by rider the same as ROP as an integrated benefit and provides guidance for the calculation of cash values (CVs). These changes, among others, will impact the design, pricing, ROP pattern and administration of ROP products going forward.

The popularity of ROP has always been offset by the additional challenges associated with this product. Several of these risks have increased in 2009, including emerging lapse experience and reserve strain driven by current economic conditions. With the introduction of AG CCC added to the mix, insurers participating in the ROP segment have a lot on their minds.

AG CCC in Brief

AG CCC applies to any life insurance policy with an endowment benefit that is less than the face amount during a point prior to the expiration of guaranteed coverage. While it applies to other product types, AG CCC has a pronounced effect on ROP term.

Under AG CCC, ROP riders and base policies will be treated in exactly the same manner. Currently, most ROP carriers sell riders. In the past, carriers could value the riders independently of the base policy, using the cash benefit only when calculating reserves. Under AG CCC, all companies have to recognize the endowment. As a result, riders may disappear, which could reduce reinsurance opportunities for direct writers.

Also, the calculation of CVs is standardized under the AG CCC interpretation of the Standard Non-Forfeiture Law (SNFL). Currently, there is considerable variation in how SNFL is interpreted by state of domicile that goes away under the new guideline. The percentage method schedules used by many companies will have to be brought into compliance with SNFL, which may have some impact on lapse.

All of these changes will mean increased design time—not only once to comply with AG CCC but perhaps several times—in order to remain compliant. Currently, ROP is a simple, straightforward program, but under AG CCC it will morph to look like a much more complicated CV whole life product.

Administrative Challenges

Under AG CCC, many CV calculations are required to support each policy and duration. If the policy is altered in any way (e.g., waiver of premium, child rider added or dropped, premium adjustment), these must be recalculated. Many term companies' administrative systems need to be updated in order to handle the formulaic calculations required under the new guideline.

If that were not enough, the new filing requirements under AG CCC are significantly more detailed than previous ones (e.g., demonstrating four different CV calculations, intermittent death benefits, present value of endowment). The costs of new systems and additional reporting may be excessive for some companies.

Lapse Rates Continue to Decline …

Many ROP writers currently offer a percentage schedule of partial refunds for CVs, a benefit that is easy for producers to sell and direct writers to administer. The pattern of percentage refunds has an impact on lapse. Life insurers have long anticipated a point at which the increase in CV exceeds the annual premium paid, known as the crossover point. At this point the

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policy begins to "fund" itself and, it is assumed, the lapse rate will drop significantly as a result.

AG CCC's impact on the calculation of cash values may affect lapse. Increased interest by the secondary market in ROP has already raised concern that lapse rates may decline to very low levels ahead of the traditional crossover point. Many insurers priced an ultimate lapse of two to three percent or more into their products. The growing consensus is that a 0.5-1 percent ultimate lapse level is more plausible (indeed, the Canadian Institute of Actuaries suggests using zero percent in *Valuation Technique Paper #1*), and companies are adjusting their premiums to reflect the emerging lapse experience.

… While Reserves Constrain Growth

Like other long-term guarantees, ROP is highly sensitive to changes in interest rates not only because of uncertainty about forward rates but because ROP has larger reserve requirements than regular term. Under XXX Section 6D "Unusual Pattern of Guaranteed Cash Surrender Values," ROP products have a longer, steeper 'hump' in reserves than for base term, the peak being roughly two times higher than non-ROP on a statutory basis under current treatment.

Because companies must recognize the endowment under AG CCC, there is the possibility of additional reserves. Under GAAP, ROP peak reserves can be as much as three times that for comparable traditional term products because the endowment is already recognized. Under AG CCC, this endowment will be recognized not only for calculation of CVs and GAAP accounting but also for statutory reserve requirements.

Recent asset devaluations have already limited the ability of companies to internally finance these relatively expensive ROP reserves. Carriers are scrambling to raise financing or obtain reinsurance to cover their in force, but cost of capital is still very high and many reinsurers are constrained in their own capacity as well. Companies will have to consider the possibility of additional reserving burdens under AG CCC.

Summary

ROP, while attractive to consumers and producers, may be losing its luster in the eyes of manufacturers. At least one company is greatly increasing its ROP rates. Another major carrier is dropping its ROP offering entirely. Emerging lapse experience has come in lower than many insurers priced for, and ROP requires significant capital—a dear commodity in the current financial environment.

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