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Universal Life, No-Lapse, and the Law vs. Free Markets

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Author's Note: This article does not necessarily represent the position of my current employer. Comments and differing opinions are welcome.

Disclosure requirements before 1975 were perhaps too minimal to assure the consumer could know the risk of not paying sufficient premiums. But modern regulations focused on illustrations and disclosure, combined with advanced marketing materials and the widespread availability of financial knowledge and advice, seem to obviate the need for such government restrictions as the minimum required benefits under the Standard Nonforfeiture Law (SNFL) . The 21st century may be the time to set the life insurance market free.

The U.S. life insurance industry seems to be at a crossroads with regard to nonforfeiture requirements. The proliferation of innovative, interest-sensitive, and flexible products is butting heads with tradition. Change seems essential to the modern market.

Background

When universal life was first popularized about 20 years ago, there was considerable controversy with regard to nonforfeiture compliance. Was it term plus a side fund? Whole life with flexible premiums? Or something entirely different? Ultimately, to meet the need for uniform regulation, the NAIC settled on the UL Model Regulation, which seemed the most reasonable and consistent interpretation of the Standard Nonforfeiture and Valuation Laws (which gave the UL Model its authority). Flexible premiums make a purely prospective model impossible; the death benefit guarantee is not predicated upon premium payments, but based upon accumulation or cash value being positive. Because the application of the Standard Nonforfeiture Law (SNFL) was unclear, the UL Model Regulation became necessary.

Although the UL Model provided relatively simple tests for cash values to meet minimum nonforfeiture requirements, it did not clearly interpret all aspects of the Standard Nonforfeiture Law. Among these were the smoothness test (originally designed to address perceived inequities in the cash values of deposit term contracts) and paid-up nonforfeiture benefits. It was unclear how or whether these applied to UL, so most states chose to ignore them, inferring that compliance with the UL Model was sufficient. Whether these are intentional omissions, oversights, or ambiguities does not obviate the need for compliance with those aspects of the law. Furthermore, when a regulation is unclear, the statute (in this case, Standard Nonforfeiture Law) prevails.

With regard to smoothness, due to this lack of regulatory enforcement, some insurers felt free to add guaranteed cash value bonus "spikes" and "cliff" surrender charges to their UL forms. Despite apparent inequities (i.e., from one policy year to the next), and their similarity to the problems of deposit term, few states chose to regulate them. Any reasonable enforcement of the smoothness test would prohibit such spikes and cliffs. However, even when removed from guarantees, insurers often feel free to create spikes and cliffs on a current or declared basis, so the restrictions are in form, not substance. Although there was some early NAIC discussion of regulating declared rates, this was quickly abandoned. In the absence of such regulation, enforcing smoothness requirements seems ineffectual.

UL Model references to paid-up nonforfeiture options seem vague and ambiguous. Many feel that UL's automatic continuation of insurance obviated the need for them. Although the continuation of insurance under UL is different from ETI in several ways, it was seen by many as an acceptable substitute for ETI. So, although the law did not change, ETI and RPU were dropped from most UL forms; some states even demanded their removal to avoid confusion between the nonforfeiture basis and the guaranteed accumulation basis (interest and COI's). Although this forced the forms into technical noncompliance, it is unlikely that the consumer lost anything significant. For most policies, switching to a paid-up nonforfeiture benefit on a guaranteed basis would be disadvantageous when compared with the typical continuation of insurance on a current basis. (In the rare cases where ETI is advantageous, a court could probably force it to be offered as a legally mandated benefit, despite its omission from the written contract.)

In terms of contract interest rates, the guaranteed credited or accumulation value rate usually equals the nonforfeiture interest rate. Tradition seems to be the primary reason. When universal life first became popular (prior to the UL Model Regulation), actuaries sought a way to comply with existing valuation and nonforfeiture requirements. The formulas commonly used to demonstrate compliance were greatly simplified if all the interest rates (valuation, nonforfeiture, and accumulation) were equal.

Despite this simplification, the standard demonstration of compliance usually consisted of 15 to 20 pages of complex actuarial formulas.

After several years of seeing such demonstrations from industry actuaries, many regulators inferred that the interest rates must be equal in order to comply. This is fallacious — lowering nonforfeiture rates produces higher minimum cash values, but lowering credited rates produces lower cash values for the same level premiums. Although this was actuarially counter-intuitive, some states would not approve filings if the interest rates were different. (This position effectively imposes rate regulation on life insurance, which is outside the authority of most states.)

Although many UL products use the same rates for the guaranteed credited and nonforfeiture interest rates, it seems entirely permissible for them to differ (at least in most states — New York, which promulgated an alternative to the UL Model, may be an exception). States which follow NAIC model laws do not regulate credited rates (guaranteed or current). The Standard Nonforfeiture Law says the nonforfeiture basis must be clearly stated; the basis used for RPU and ETI must match the nonforfeiture basis for the contract (but may differ from the guaranteed credited rate and COI's). Few UL contracts have RPU or ETI, so the guaranteed credited rate is usually the only rate in the contract.

Derivation of No-Lapse Provisions & Associated Reserving & Nonforfeiture Issues

In the early days, some UL would have minimum premiums required for one to five years. Because the period was so minimal, no cash values would have been required even if this was a fixed premium requirement. The requirement was principally designed to improve premium persistency. (Some additional reserves may be indicated, but these were sometimes ignored as being immaterial.)

Later, some illustrations were enhanced to improve disclosure. They stated that the policy would continue if a specific premium were paid. Some states even required this type of disclosure, e.g., "This policy will lapse in year xx without additional premium."

"No-lapse" provisions have been designed several ways, with more possibilities likely to be created. No-lapse provisions guarantee the death benefit even if the (primary) account value or cash value is zero (or negative). When the no-lapse premium is **fixed**, i.e., neither advance funding nor "catch-up" funding is allowed by the contract, the Standard Valuation and Nonforfeiture Laws appear to apply. If such a fixed feature is added to a variable contract (i.e., based upon a separate account), the no-lapse feature seems to be the primary death benefit guarantee; the value of the variable account is irrelevant as long as the fixed no-lapse premium is paid. Perhaps the laws and/or guidelines need to be revised to regulate such fixed guarantees. Establishing a separate account does not obviate the need for minimum reserves and cash values.

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Cumulative no-lapse guarantees operate similarly to typical UL accumulation values. They are generally considered secondary guarantees, and are sometimes called "shadow accounts." They only have value when cash or accumulation values drop to zero (or below). Most of them guarantee death benefits as long as the sum of gross premiums paid to date is at least as great as the sum of no-lapse premiums. Some provisions allow "catch-up" premiums to be paid later. (In these cases, failure to pay the no-lapse premium has no effect if the cash value is greater than zero. Once the cash value becomes zero, the policyholder would have until the end of the grace period to "catch-up" with any no-lapse premiums not previously paid). This can be viewed as a secondary accumulation value. Gross premiums are added; at the end of each year, the no-lapse premium is subtracted. If the result is nonzero, the no-lapse guarantee is in effect. However, if the policy cash value is positive, the no-lapse account value is ignored, even if it is negative.

When a **cumulative** no-lapse guarantee is used, there is no fixed prospective premium requirement upon which to base minimum cash values and reserves. This is the same situation as in flexible premium UL, so it seems appropriate to base valuation and nonforfeiture requirements upon the UL Model. If the standard UL methods are used to calculate no-lapse reserves, it seems appropriate to hold the greater of the no-lapse reserve and that using the standard UL account value method. The no-lapse GMP seems to be the level no-lapse premium to the latest date of the no-lapse guarantee. As UL designs expand, guidelines may be needed for appropriate reserves.

However, the logical conclusion seems different for nonforfeiture. The cash value provided by UL contracts is not usually affected by no-lapse guarantees, although insurers could offer greater cash values along with no-lapse. If the basic cash values of a UL contract meet the minimum nonforfeiture requirements of the UL Model, those cash values comply with the Standard

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Nonforfeiture Law. If the **cumulative** no-lapse guarantee does not reduce the cash values, the Nonforfeiture Law is still satisfied. So the application of UL Model nonforfeiture principles to a **cumulative** no-lapse guarantee seems to exempt such guarantees from additional cash value requirements. (Note that the payment of a level premium for a death benefit guarantee on a stand-alone basis would require minimum cash values, at least for certain issue ages, classes or for longer guarantee periods.)

Under UL Model nonforfeiture, it is theoretically possible to have zero cash value (e.g., through large level loads) despite level premiums to maturity. However, regulatory, market, and political pressures prevent insurers from marketing such products.

Although secondary guarantees generate an additional reserve need, it is possible to have level premiums with no cash value from the secondary guarantee, because the UL Model only tests the load on the primary accumulation value.

Converting a fixed premium product to flexible premium can eliminate minimum cash values. To some, it seems unreasonable that adding a flexible premium provision could circumvent standard equity requirements. (Addition of a separate account confers an even broader exemption.)

The question is, should we demand cash values on cumulative no-lapse, i.e., impose the UL Model test on surrender of the shadow account, or allow zero cash values? Is it unfair to require persisting policyholders to pay part of the reserve to terminating policyholders, thus increasing the cost of insurance? If zero cash values are permitted, will the viatical market take over, and is that a desirable alternative?

Illustration - No Lapse Reserves and Nonforfeiture Values

Consider, for example, a whole life product. Suppose the annual gross premium equals the net level premium using 90% of 1980 CSO with interest at 5%. The basis of the fixed premium is not subject to regulation — indeed, it is generally not disclosed. Now suppose the nonforfeiture basis is 1980 CSO @ 5.75%. This generates a set of minimum cash values. (Note that the minimum cash values do not equal gross or net premiums accumulated at 5%.)

Now suppose this is changed to fixed premium UL, with guaranteed interest on the accumulation value set at 6% for the first 10 years, then 3%, with 1980 CSO for COI's. Because this accumulation value basis is independent of the nonforfeiture basis, guaranteed accumulation value will not equal the minimum nonforfeiture cash value. Assume the policy offers the greater of accumulation value and minimum cash values on the nonforfeiture basis. This is clearly in compliance with the law, despite differences among all the policy interest rates.

Suppose this fixed premium UL is further amended to add a flexible premium provision. The fixed premium is no longer required (although it could be used as a "suggested" planned premium). Further assume that no front-end or level loads are imposed, but a surrender charge is levied.

Under the UL Model, this contract complies with nonforfeiture law as long as the surrender charge does not exceed the unamortized nonforfeiture expense allowance. The minimum cash value table can be omitted. However, if the "suggested" planned premium (which was the fixed premium) is paid, the design of the UL Model should operate to keep cash values up.

Now the company wants to add a cumulative no-lapse guarantee. If the sum of gross premiums received is as much as the sum of no-lapse premiums to date, the contract is guaranteed not to lapse. Assume the no-lapse premium is set equal to the "suggested" planned premium. At that premium level, the contract value cannot drop to zero anyway. In effect, the no-lapse guarantee adds nothing to the contract (except perhaps "consumer comfort" or better marketing "spin"). Likewise, it should create no additional reserve requirement, and no additional requirement of minimum cash values.

Suppose the company later decides to be a bit riskier. It cuts the no-lapse premium by 20%. Because the no-lapse premium is flexible, it operates similar to the primary UL account value. The cash value guarantees of the contract have not been diminished, so they are still in nonforfeiture compliance, i.e., because the surrender charge does not exceed the limits in the UL Model Regulation.

However, the reserve need clearly increases, because the death benefit is guaranteed to maturity for a smaller premium (the reduced no-lapse premium). Whether the additional reserve is compelled by Regulation XXX, the UL Model, or Standard Valuation Law is subject to discussion. Some would claim that GMP now equals the no-lapse premium. Others would say that because the no-lapse premium does not *endow* the product at maturity (it just carries the death benefit to maturity), GMP has not changed.

Some claim that the guideline annual premium drops to the no-lapse premium; others say that guideline calculations are unaffected, because endowment is not guaranteed when no-lapse premium is paid. (Another argument against the guideline premium becoming the no-lapse premium is the possible difference in treatment under Section 7702 from

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two otherwise identical policies, where the only difference is the level of the no-lapse premium.). Enhanced regulations or actuarial guidelines may be needed for no-lapse reserves.

Consumer and Market Perspectives

Considering current-basis COI's and declared interest rates, in most cases it is unlikely that payment of the no-lapse premiums would result in low cash values anyway. This may make the enforcement of guaranteed minimum value requirements superfluous. Ultimately, the consumer must be served if the industry, its stockholders, and even its regulators (witness "speed to market") are to survive. But what does the consumer want?

Some clearly want the lowest price possible. The power of cost-conscious consumer demand has created the hot term market. Those who want long-term guarantees have to face what may seem unreasonably higher rates, designed at least in part to avoid cash value requirements.

There are still many consumers who want minimum cash values to hedge their risk of not being able to pay the premiums. Traditional and low-accumulation UL can satisfy many of their needs. But here again, the consumer is forced to buy UL, not whole life, to get the lowest level premium possible. To meet the need, some UL develops extremely low cash values on a low-premium basis. Yet, despite UL's flexibility, some insurers have resorted to considerable ingenuity (some call it gimmickry) to create products which meet the needs of the current marketplace.

Some fear that the loosening (or abolition) of minimum nonforfeiture requirements not only would result in inequities, but would undesirably expand the market for viatical dealers. Although it seems unfortunate that some marketers abuse viaticals to take unfair advantage of the ill and uninformed, this does not justify restricting the rights of competent contract owners to sell their property, i.e., their insurance contracts.

Clearly, such arrangements often do more to relieve welfare burdens, preserve dignity, and alleviate suffering than any other remedy. Furthermore, the rapid expansion of the viatical market, despite opposition from some regulators, indicates that viaticals are filling a void, meeting a real consumer need.

Within the industry, the proliferation of policies allowing acceleration of benefits satisfies some of the need. More freedom to accelerate, e.g., for chronic or critical illness or disability, would expand this.

If the industry did not fear the social, political, and regulatory repercussions, it could also be an efficient, effective, and equitable source of viatical settlements. In fact, if a company buys back its own policies, i.e., when it determines that their present values exceed cash values, it would eliminate many of the risks of current viatical transactions (e.g., selling to someone who stands to gain by the insured's early demise). In buying its own contract, the insurer could simply cancel the contract, release the reserve, and post the gain — a win-win "deal."

Many are concerned about maintaining a "level playing field." Moving a product out of the general account, i.e., creating a variable product out of a non-variable one, is already an available option that exempts policies from many state valuation and nonforfeiture requirements. Out-of-state groups are created to enable marketing in "difficult" states. Insurers (and even some state regulators) "bend" the rules or "push the envelope." These, plus the proliferation of reinsurance and international insurance arrangements oblivious to (or to circumvent) U.S. regulation, have made and will continue to make the "playing field" increasingly non-level.

Moreover, it seems that the consumer (and the insurer) ought to have the choice.

Consumer awareness, coupled with enhanced disclosures, and compounded by continuing market pressures, imply that the need for the fixed minimums required by SNFL may be obsolete. Indeed, the 21st century may be the time to set the market free.

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