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Regulators Respond to Industry "Innovation" Through Guideline AXXX

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LHATF approved this regulation at the June NAIC meeting based on the May 1, 2002 draft which had minor changes from which this article was based.

It has been two years since XXX went into effect. Since that time, we have seen aggressiveness, creativity and innovation in product design, as well as some blatant attempts to skirt the regulation. The regulators of the NAIC's Life and Health Actuarial Task Force (LHATF) have responded to this "innovation" through Actuarial Guideline AXXX, the Application of the Valuation of Life Insurance Policies Model Regulation (AXXX). This guideline is still in draft form. It is expected that the NAIC will adopt AXXX at its next meeting this March. The purpose of the guideline is to provide direction as to the application of XXX to various product designs. It is not meant to address all possible designs, but rather to give guidance as to the intent of XXX. AXXX is broken into eight sections, with each section providing direction as how to apply XXX to a specific product design. While AXXX lacks full industry support, there is general support for the first seven sections. The eighth section specifically addresses universal life (UL) plans and is the area of much controversy. Each section is addressed below as well as some examples of product designs that fall under each section. The examples in the first six sections under AXXX tend to concentrate on premium rates, however, they are also applicable to premium loads and cost of insurance charges in universal life plans, which can (and have been) manipulated to provide a type of no-lapse or secondary guarantee.

The eighth section specifically addresses universal life (UL) plans and is the area of much controversy.

Section 1 - Increase Tied to an External Trigger

These plans provide that a carrier may only increase premium rates (or loads in a universal life plan) if a certain external event occurs, such as the Treasury rate dropping below a certain level. Since the insurer does not have the unrestricted right to increase premiums, AXXX requires that companies reserve these plans as if the premium were guaranteed for the full level-premium period.

Section 2 - Refund of Premium (Partially Guaranteed)

Carriers offering this type of product agree to refund the premium if the rates are increased during the projected level-premium period. These designs generally include a specified window of time for the policyholder to exercise the option/right for the refund and if the option is exercised, the policy is generally cancelled. For universal life plans, the option is generally only available if the increase would otherwise cause the policy to lapse.

Under these designs, the insurer's right to increase premiums is not unrestricted due to the requirement to provide additional benefits. AXXX states that companies must reserve for these types of policies over the entire level premium or secondary guarantee period.

Section 3 - Affiliated Company Guarantee

These policies have an initial guaranteed level premium. After the initial premium guarantee period, the policyowner is protected against future premium increases. This protection is provided by a second company through reinsurance, a second policy issued to the consumer or an agreement between the two companies. AXXX requires that the combined reserve of the direct writer and the second company be that which the direct writer would have held absent the second company and based on the entire level-premium period. The direct writing company may take reserve credits only if the agreement between it and the second company meets the requirements under the applicable reinsurance regulations.

Section 4 - Refund of Premium (Fully Guaranteed)

This design has high gross premiums, which are guaranteed. It also provides a cash value, dividend or premium refund after a certain period of time. The dividend or refund has the effect of creating a low "net guaranteed premium." In some designs, the amount of the refund or available cash value has equaled the sum of premiums paid after a certain period.

AXXX will require that companies offering this type of design must use the net premiums (gross premium less amount of refund, dividend or cash value) in the reserve calculation.

There was some concern in the industry that coinsurance allowances under reinsurance treaties could be interpreted to fall under this category. AXXX treatment under this section is not intended to apply to coinsurance allowances under bonafide reinsurance agreements.

Section 5 - Re-entry Plans

These plans have an initial rate or no-lapse guarantee period. At the end of the initial rate guarantee period, the policyholder has the contractual right to re-enter to a second plan with no or little evidence of insurability. For some universal life plans, the right to re-enter occurs if the cash value falls below zero during the no-lapse guarantee period (rather than only at the end of the period) and is available only if the stipulated premiums have been paid. The new or substitute plan generally provides an additional level premium period at specified favorable rates.

AXXX will require that the initial re-entry periods and premiums be treated as a continuation of the initial guarantees. The original policy reserves are to be determined over the entire period; the reserves for the substitute policy are to be determined as if the coverage had been issued at the issue age and issue date of the original policy.

Section 6 - Level Net Reinsurance Premiums

This section addresses at least one "innovative" approach to reinsurance that several reinsurance providers used in their treaties to ultimately shorten a guarantee. Essentially, in a case where the direct writers' premiums are guaranteed for X number of years, the reinsurance treaty provides level premiums on a current scale for X years, but directly guarantees the premiums for a shorter number of years. If the reinsurer increases the premiums, it also agrees to increase the expense allowances such that the net payments for the direct writer remain unchanged.

The regulators' view is that "the additional 'expense allowance' has no relationship to the expenses actually incurred by the direct writer in administering the reinsured policies." Therefore, under AXXX, the reinsurer, in its reserve calculation, needs to establish the reserve using an initial segment equal to the full level premium period and the valuation premiums should be level over that period.

With respect to term insurance, most of the innovative designs were put in place to try to mask a partially guaranteed plan as guaranteed, as evidenced by the first five sections of AXXX. The introduction of these innovative designs has slowed over the past year. This slowdown is most likely attributable to AXXX and the market's demand for fully guaranteed plans.

With respect to universal life plans, there has been little "innovation" in design in response to XXX. Most of the new UL plans that companies introduced in 2001 were similar in design to their pre-XXX counterparts, and included both secondary guarantees and catch-up provisions. There has, however, been an increase in the number of plans that incorporate shadow account designs.

Secondary guarantees are generally one of two forms, accumulation of premium or shadow account. Both designs are subject to AXXX and the area of controversy surrounding this guideline. The accumulation of premium designs provide that a policy will stay inforce, regardless of the underlying cash value of the policy, as long as specified premiums have been paid. Secondary guarantees of this form are already clearly addressed under XXX. Shadow account designs have become more prevalent over the past two

continued on page 12

years. These are similar to accumulation of premium designs. These plans generally allow a policy to stay inforce even if the calculated account value or cash surrender value becomes negative as long as the shadow account remains positive. The shadow account is generated in a manner similar to the account value, but uses charges and/or credits more favorable than the guarantees in the basic/underlying policy.

Catch-up provisions are also prevalent. These are basically added to accumulation of premium types of secondary guarantees. They allow a policyowner to reinstate a secondary guarantee or move from a shorter secondary guarantee to a longer one by paying the difference between the cumulative required or "no lapse" premiums and the actual premiums paid to date.

The final two sections of AXXX specifically address catch-up provisions (Section 7) and secondary guarantees (Section 8).

Section 7 - Premium "Catch-Up" Provisions

In general, this is the one area in which AXXX provides some relief over a strict reading of XXX. Regardless of whether or not the policyowner is meeting the premium requirements to keep a secondary guarantee inforce, reserves for plans that include "catch-up" provisions must be computed, assuming the longest guarantee period is met. However, it then allows companies to proportionately reduce the basic and deficiency reserve amounts by any "catch-up" amount required on the valuation date in order to maintain the guarantee, not to be reduced below zero.

Section 8 - Secondary Guarantee Requirements

AXXX addresses both the accumulation of premium and shadow account designs. Under the guideline, any amounts already paid by the valuation date which may reduce the amount of future premiums necessary to satisfy the secondary guarantee requirements need to be added to the reserve. The total amount is capped by the net single premium for the coverage on the valuation date. The latest draft, dated 12/6/01, does provide some additional relief for deficiency reserves and for surrender charges to be taken into consideration to reduce the amount of reserve.

This approach relies on actual premium payment history and some feel that incorporating the actual premium payments results in a modification to XXX and the UL Model Regulation. The UL Model Reg. calls for determination of premiums "at issue" and prepayments can not be determined at issue. If a policyholder prepays, all else being equal, his or her policy will have a higher cash surrender value than if it was paid annually. Since the obligation to keep the secondary guarantee in force requires less future premiums to be paid, AXXX requires that the company set up a higher reserve than if no prepayments had been made. This increased reserve is in addition to the "floor" established by the UL Model Reg. for highly funded policies.

This section lacks full industry support and is the area of much controversy. Some individuals feel that relying on actual premium payments is a modification to XXX and the UL Model Reg. in that it calls for determination of premiums "at issue" and prepayments cannot be determined at issue. As such, some feel that such a change can not be accommodated through a guideline, but rather would require revising the regulations. Additionally, incorporating any pre-funding may materially change the required reserves for even the most modest secondary guarantees. Many companies priced these guarantees with a "good-faith" interpretation of XXX and, in many cases, reserved for them in a method agreed upon with the regulators.

For all but Section 8, the effective date for AXXX will be retroactive to the date XXX became effective in a particular state. The retroactivity may have a negative impact to companies and reinsurance providers that offered products or "guarantees" covered under one of these sections, especially if they took an aggressive interpretation to reserving under XXX.

The calculation approach defined under Section 8 will require many companies to reprice UL products, at least with respect to prepayments. Additionally, it will take companies some time to modify their systems to generate the proposed reserves, which incorporate actual premium payments. As a result, most of Section 8 will not be retroactive; the proposed effective date is currently January 1, 2003. The first two steps in the calculation described in Section 8 will be retroactive. These basically clarify how to define "minimum gross premiums" and "specified premiums" in XXX, but ignore actual premium payment history. ❖

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