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AG 38, ULSG AND THE SPIRIT OF XXX

By Kristin Norberg

Actuarial Guideline XXXVIII (The Application of the Valuation of Life Insurance Policies Model Regulation, herein referred to as "AG 38") has an extensive history, resulting in part from the diverging efforts of "innovative" product designers on the one hand and "conservative" state regulators on the other.[1] The guideline was introduced by the National Association of Insurance Commissioners' (NAIC's) Life and Health Actuarial Task Force (since renamed the Life Actuarial Task Force, or LATF) during 2002 in order to demonstrate reserving approaches that would comply with the Valuation of Life Insurance Policies Model Regulation (known as Regulation XXX) for various policy features that constitute guarantees.[2]

AG 38 begins with a reference to "common sense … professional responsibility … [and] compliance with both the letter and the spirit of the law," all concepts that LATF chose to emphasize in the context of the product innovations of the early 2000s.[3] As companies have continued to innovate since then in efforts to make low-cost guaranteed coverage available to consumers, the NAIC and LATF have responded by continuing to elaborate upon the underlying principles and "spirit" of XXX and AG 38. In 2005 and 2006, the guideline was expanded to reflect specific product assumptions, lapse assumptions, and a stand-alone asset adequacy analysis for UL contracts with secondary guarantees (ULSG). The latest installment of the guideline, adopted by the NAIC on Sept. 12, 2012,[4] expands the ULSG requirements to incorporate the deterministic reserve under principle-based reserves (PBR),[5] a stand-alone Actuarial Memorandum, reporting related to reinsurance transactions, collection and review of all related memoranda by the NAIC's Financial Analysis (E) Working Group (FAWG), and even specific requirements for the design and filing of new ULSG products.

With these revisions, AG 38 now has five subsections, 8A through 8E, that apply to ULSG policies issued in various time periods. Section 8D of the latest update also introduces a variation by statutory reporting years for some blocks of business. Since the Internal

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Revenue Code (IRC) Section 807(d)(3) defines the tax reserve method to be "the Commissioners' Reserve Valuation Method prescribed by the National Association of Insurance Commissioners which is in effect on the date of the issuance of the contract,"[6] the complex generational structure of AG 38 results in an array of applicable methods for determining the federally prescribed reserve (FPR) for a ULSG contract. This article will present a brief history of the situation and discuss some of the key challenges for tax practitioners as they consider the AG 38 revisions.

THOSE INNOVATIVE ACTUARIES

Actuaries responsible for statutory and tax reserve valuation at most companies in the ULSG marketplace need to deal with several generations of product design, each having issue dates that may or may not coincide with the generational changes in the AG 38 language. In general, a product with a "secondary guarantee" provides that a policy will remain in force at the original schedule of benefits if the stated secondary guarantee conditions are met, which may involve either payment of a specified premium or sufficient funding of a side "shadow" fund, depending on the design.

The earlier, specified premium design clearly came under the scope of Section 7 of Regulation XXX, which sets valuation standards for flexible and fixed-premium UL policies with secondary guarantees.[7] Shadow accounts presented a somewhat more complex situation, though. A shadow account operates like a typical UL fund value except with different charges and credits that are generally more favorable than the guaranteed charges and credits in the base policy. Since the objective is to provide death benefit coverage beyond the period for which the benefits would be available at a given funding level under the base policy, shadow accounts do not provide an additional cash benefit. There were conflicting viewpoints initially about whether XXX applied to shadow account products, since the regulation does not describe the design itself but rather refers to "a policy in which the minimum premium at any duration is less than the corresponding one year valuation premium" at defined assumptions.[8]

AG 38 confirmed that shadow accounts were indeed within the scope of XXX, with that clarification also applicable to policies issued in prior years starting from the adoption of XXX.[9] Prospectively, AG 38 defined a nine-step approach for calculating ULSG reserves that reflects the extent to which the shadow account or specified premium guarantee has been pre-funded by the policyholder. An abbreviated description of the generic steps of this "Example 8 approach" follows:[10]

> Steps 1–2. Calculate minimum gross premiums for the secondary guarantee, and use those for the initial XXX basic (Section 7B) and deficiency (7C) reserves. Call this XXX_{7B+7C}.
>
> Steps 3–4. Calculate the funding ratio, based on actual pre-funding relative to fully funding the remaining secondary guarantee (on a single-premium or paid-up basis).
>
> Step 5. Calculate the net single premium under statutory mortality and interest standards for the remaining secondary guarantee period. Call this NSP_{SG}.
>
> Steps 6, 8. Use the funding ratio (indirectly restricted to be between 0 and 1)[11] to establish the total AG 38 Example 8 reserve at a point in the "corridor" between the XXX_{7B+7C} floor and the NSP_{SG} cap, and then subtract surrender charges, as follows:
>
> $TotalEx.8reserve = XXX_{7B+7C} + (fundingratio * [NSP_{SG} - XXX_{7B+7C}])$, less the surrender charge actually applicable (*i.e.*, account value minus surrender value).

Steps 7, 9. If the resulting total Ex. 8 reserve is greater than the initial XXX_{7B+7C} reserves, then reallocate between deficiency and basic amounts as follows:

Final (reduced) deficiency reserve = initial XXX_{7C}* (1 – funding ratio).

Final basic reserve = total Ex. 8 reserve – reduced deficiency reserve.

After completing these steps, the actuary would adjust for any catch-up provisions according to Section 7 of AG 38 and then return to XXX Section 7D to apply a floor at the normal UL Commissioners' Reserve Valuation Method (CRVM) reserve and at the unearned valuation cost of insurance (½ c_X).[12]

When the original AG 38 was adopted, many companies introduced designs that focused on step 4—the single premium to fully fund the shadow account for the remaining secondary guarantee period (or segment). One common approach was to develop an array of premium loads that may apply to a payment, or to portions of a payment, where the rates depend on the actual level of funding in each year. The loads were typically designed so that the single-premium funding requirements would be relatively high while level-premium funding patterns remained competitive. However, the 2005 amendment of AG 38 essentially eliminated the statutory reserve impact of these designs by introducing Section 8B, in which step 4 requires a standardized 7 percent premium load assumption.

Next, attention shifted to step 1—the minimum gross premium to satisfy the secondary guarantee. Many companies offered products where two alternative scales of cost of insurance rates or interest credits would apply to the shadow fund based on criteria defined in the contract. In the common "dual shadow account" design, for example, a premium is applied to the account with the more favorable rates as long as the shadow account is positive (*i.e.*, at least $0.01), and to the second account otherwise, with the less favorable charges being assessed as long as value remains in the second account. Whether dual account or not, these designs are such that a policyholder paying a level premium, and paying it always on time, would be eligible for the more favorable rates, while a policyholder who has fallen behind or is paying on a YRT type of pattern could be subject to the less favorable rates.

THE $0 TO $0 RULE

The language that has been primarily at issue in the most recent iteration of AG 38 relates to that last design and its treatment relative to Section 7A(4) of Regulation XXX. Section 7A(4) reads, in pertinent part: "the minimum premium for any policy year is the premium that, when paid into a policy with a zero account value at the beginning of the policy year, produces a zero account value at the end of the policy year" (herein referred to as "the $0 to $0 rule").[13] Generally, this was understood to mean that the minimum premiums to be used for purposes of valuation were an increasing scale based on the charges and credits for each year of coverage, rather than a level premium like the UL Model Regulation's guaranteed maturity premium.[14] Specifically, though, many companies followed this section literally, concluding that since a premium paid when the shadow account is exactly $0.00 would be subject to the less favorable rates in their product designs, then the minimum premiums defined by XXX in this circumstance are those needed to fund the less favorable scale of charges for each year. This interpretation results in higher minimum valuation premiums and, generally, lower reserves than would be obtained using the more favorable rates.[15]

Many companies offered products where two alternative scales of cost of insurance rates or interest credits would apply to the shadow fund based on criteria defined in the contract.

State regulators, through oral and published statements and ultimately through the 8D and 8E updates to AG 38, have made it clear that this was not the expected result. A statement drafted by LATF and formally adopted by them on Nov. 1, 2011, stated:

> The correct application of the requirements and Actuarial Guideline XXXVIII, Section 8, Step 1, for these product designs is to derive the "minimum gross premiums" that represent the *lowest* schedule of premiums a policyholder could pay to satisfy the secondary guarantee. For the product design described above, the lowest schedule of minimum gross premiums a policyholder could pay to reflect the benefits of the secondary guarantee is derived by applying the secondary guarantee with the lowest set of charges and/or highest crediting rates.[16]

TAX RESERVE CONSIDERATIONS

There are a number of interesting aspects to this situation as it relates to tax reserves. One of the most obvious is the

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complexity of the generational statutory guidance, which is of course critical to understand since IRC 807(d)(3) points to the NAIC-prescribed method in effect on the date of the issuance of the contract. The history of this statutory guidance is summarized in the "Calendar of AG 38 Applicability—Statutory Valuation" (shown below) along two dimensions: horizontally as a timeline by issue date of a ULSG contract, and vertically by the hierarchy of authority.

A comparison of the AG 38 adoption dates with the corresponding (statutory) issue date ranges on the Calendar illustrates that the previous updates had varying rules for statutory applicability. Steps 1 and 2 of the original Section 8 (now 8A), as well as Sections 1 through 7 of the guideline, were viewed by the NAIC in 2002 as clarifications to the existing model regulation so were applicable from the original effective date of XXX. The NAIC distinguished steps 3 through 9 of Section 8A as a new interpretation that would apply prospectively only, starting from Jan. 1, 2003. Similarly, Sections 8B and 8C each introduced new interpretations and new factors for certain assumptions, and they were applied prospectively starting from July 1, 2005, and Jan. 1, 2007, respectively.

The latest revisions and statements present a different situation, in which certain state regulators denied the specific application of the $0 to $0 rule in the context of products with multiple scales of charges or credits, arguing that the use of higher gross premiums is (and has been) inconsistent with the requirements of CRVM as already defined by XXX and inter-

CALENDAR OF AG 38 APPLICABILITY - STATUTORY VALUATION

APPLICABLE TO CONTRACTS ISSUED:

	1/1/2000 →	1/1/2003 →	7/1/2005 →	1/1/2007 →	1/1/2013 →	??
Law:	**Standard Valuation Law (Model 820)** -Section 5 defines commissioners' reserve valuation method (CRVM) -Section 8 (1976) defines alternative minimum reserve (AMR), or deficiency reserves					Life PBR
Regulation:	**Valuation of Life Insurance Policies Model Regulation (Reg. XXX, Model 830)** - Adopted Mar. 1999 - Section 7 describes basic and deficiency reserves for ULSG					
Actuarial Guideline:	**AG 38 Example 8A (steps 1-2 only)** - Adopted Sept. 2002 - Clarifies that shadow accounts do fall under XXX Section 7, using the minimum gross premiums as the "specified premiums" for basic and deficiency reserves	**AG 38 Example 8A** - Adopted Sept. 2002 - Introduces an additional reserve based on any actual pre-funding of the secondary guarantee - Defines denominator of funding ratio as the single premium needed to fund the remaining secondary guarantee, assuming minimum gross premiums have been paid through the valuation date - Applies a cap at NSP using defined select factors (not X-factors) - Allows total reserve to be reduced by applicable surrender charges - Reduces XXX deficiency reserve by the funding ratio; generally reallocates that amount as basic reserve	*For NAIC annual statements 2005-2011* (and 2012+ for 8D exclusions) **AG 38 Example 8B** - Adopted Oct. 2005 - Changes to a standard 7% premium load allowance for denominator of funding ratio **For NAIC annual statements 2012+** (*with some exclusions; see note 20*) **AG 38 Example 8D** - Adopted Sept. 2012 a. Primary reserve methodology - Starts with company's existing (year-end 2011) interpretation of 8B / 8C - Adds excess if needed to hold at least the VM-20 deterministic reserve (with market-based investment earnings and discount rates) b. Alternative reserve methodology - Allows reserve based on LATF interpretation of 8B and 8C (with XXX deficiency reserve mortality/lapse based on VM-20 deterministic reserve) c. Requires stand-alone Actuarial Memorandum, with copy to NAIC FAWG	**AG 38 Example 8C** - Adopted Sept. 2006 - Introduces lapse rates - Requires stand-alone asset adequacy analysis - Clarifies that ULSG reserves are still segmented as in XXX - Accompanied by Model Reg. 815 introducing 2001 CSO preferred class structure mortality tables	**AG 38 Example 8E** - Adopted Sept. 2012 - Defines minimum gross premiums explicitly based on the LATF interpretation; three safe harbor designs plus extensive guidance for considering alternative designs - Limits the actual shadow account credits for the safe harbor designs, based on corporate bond index - Develops rules for negative funding ratio - Uses a reduced surrender charge related to remaining secondary guarantee period - Requires specific Actuarial Opinion and Company Representation for all products offered in 2013+, with copy to NAIC FAWG	

Other relevant guidance:

Revised XXX Practice Note (AAA)	LATF Statement on AG 38
- Adopted Dec. 2006 - Describes minimum premium "to carry the shadow account from one anniversary to the next"	- Adopted Nov. 2011 - Requires use of "*lowest* schedule of premiums a policyholder could pay to satisfy" the guarantee

Abbreviations:

AAA	American Academy of Actuaries
FAWG	Financial Analysis (E) Working Group
LATF	Life Actuarial (A) Task Force
NAIC	National Association of Insurance Commissioners
NSP	Net single premium
ULSG	Universal life insurance with secondary guarantees
VM-20	"Requirements for Principle-Based Reserves for Life Products," in NAIC valuation manual (adopted Aug. 17, 2012 or later), specifically Section 4: "Deterministic Reserve"

preted by AG 38.[17] AG 38, after all, included a specific "letter and spirit of the law" clause in its introduction.[18] Rather than conceding, as with the tiered premium load design discussed above, that companies were in fact using the prescribed method and that the prescription needed to change accordingly to eliminate a loophole, LATF asserted with respect to the determination of minimum gross premiums that "the requirements are clear and no changes or clarifications are needed to these requirements."[19]

In addition to the unambiguous opinions asserted in LATF's Nov. 1, 2011, statement, the final AG 38 framework in Sections 8D and 8E underscores the regulators' position that the use of multiple scales of charges and credits in order to reduce reserves was simply not consistent with the prescribed method. Section 8D, applicable for most in-force business subject to either 8B or 8C,[20] allows companies already following the LATF interpretation to continue with their current reserve approaches and levels. Companies not following the "correct" interpretation must hold an additional amount based on the PBR deterministic reserve, to the extent that it exceeds the reserve developed using their existing 2011 statutory method.

Section 8E, applicable for new business starting in 2013, explicitly requires that the minimum gross premium be based on "the set of charges and credits … that produces the lowest premiums." In painstaking detail that expanded step 1 from one sentence to well over a page of text (plus a page of new reporting requirements), Section 8E reiterates the LATF interpretation for the targeted design while also attempting to prevent future "aggressiveness" related to the minimum gross premium component of the reserve, even imposing limitations on the guaranteed policy credits that companies can offer.

One question this history raises is whether the federally prescribed reserve should be modified on in-force ULSG business to use the "correct" interpretation as put forth by LATF. Although the "$0 to $0" language was part of XXX, regulators contended that the particular designs and interpretations described above were inconsistent with the underlying principle of the regulation, which is that "similar reserves be established for policy designs that contain similar guarantees."[21] In other words, the existing method couldn't have been CRVM because it was *incorrect* in the regulators' eyes. Although many companies disagree with that version of the tale, it appears

that tax practitioners could develop arguments for a change in basis for the FPR so that the tax reserve method conforms to "the letter and spirit" of XXX through use of the lowest minimum gross premium, at least if the statutory basis were changed fully to that method as well.[22] The Internal Revenue Service (IRS) could well view such a change in basis as being subject to the 10-year spread under IRC Section 807(f).

A related question is whether an IRS challenge to such a conforming change would create a situation similar to TAM 200328006, which as various commentators have discussed in previous issues of *Taxing Times*, was one of the ruling positions that led to the *American Financial* case.[23] Peter Winslow wrote:

> In TAM 200328006 (March 20, 2003), the IRS adopted the position, in a case involving AG 33, that tax reserves for contracts issued before the effective date of a new actuarial guideline cannot take the guideline into account. The TAM ignored the fact that at least some of the taxpayer's statutory reserve changes may have been permissible interpretations of CARVM when the annuity contracts were issued prior to the adoption of AG 33.

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An important implication of this TAM was that if it had been upheld and the taxpayer had not been allowed to use AG 33 as its tax reserve method for contracts issued prior to the date AG 33 was adopted by the NAIC, then two companies that had essentially identical products issued in the same years would be subject to two different tax reserve requirements.

This anomaly can arise in the current instance as well. Assume that for a shadow account product sold in 2008, Company A already held reserves based on the lower minimum gross premiums prior to adoption of the revised AG 38, while Company B used the higher premiums. If Company B were to change its statutory reserves fully to the "correct" interpretation of XXX as maintained by LATF (following the "Alternative Reserve Methodology" of AG 38 Section 8D.b), and if the IRS were to refuse a corresponding change to the FPR for Company B, then Company A and Company B would have essentially identical products but two very different levels of FPRs.

To complicate the situation, assume Company C previously used the higher minimum gross premiums but elects instead to switch to the compromise "Primary Reserve Methodology" of AG 38 Section 8D.a for its affected in-force business. As described above, under this compromise, companies maintain their existing statutory method from 2011 as a baseline and add an amount based on the deterministic reserve defined in VM-20—*i.e.*, a component of PBR. Clearly the addition of a PBR deterministic reserve was not part of CRVM on the date of issuance of the contract, so that would be difficult to support as a viable tax reserve method for Company C. But since the existing statutory reserving approach was not consistent with the NAIC interpretation (the "spirit of the law" wording in the AG 38 introduction), it also seems inappropriate to consider the old approach to be CRVM for tax reserve purposes.

Regardless of the position a company takes on the tax reserve method for the FPR, a good argument exists that any increase to a policy's statutory reserve as a result of the VM-20 deterministic reserve excess according to AG 38 Section 8D.a.2 should be considered part of the statutory cap for that policy, as has been argued for the CTE amount in AG 43.[24]

WHAT'S NEXT FOR AG 38?

During the preparation of this edition of *Taxing Times*, on Oct. 29, 2012, the NAIC formed a new working group "to provide timely actuarial guidance for companies seeking to comply with the revisions to Actuarial Guideline 38 (AG 38) with respect to both in-force and prospective business."[25] The working group, which will report to the NAIC's Financial Condition (E) Committee, is charged with considering questions submitted to it by state regulators and companies and releasing guidance after an abbreviated public review and comment period. The guidance is intended to be binding for purposes of FAWG review, thus imposing another layer of guidance on the already complex ULSG landscape.

In other work, the NAIC has been exploring the use of captive insurance companies and other special purpose vehicles, which have been used by many companies to improve their positions related to capital-intensive products under XXX and AG 38. To the extent the allowed or viable structures change as a result of this work, companies will also need to consider tax consequences of their financing decisions.[26]

Additionally, as indicated at the right side of the Calendar, AG 38 is intended to be replaced for statutory purposes by PBR when it is adopted. The latest installment of the actuary/tax attorney dialogue in this issue explores the current status of that major initiative. PBR is in many respects the ultimate "spirit of the law" approach to the valuation of XXX reserves, so it will be interesting to see what may arise as the X-rated saga continues. ◂

The views expressed are those of the author and not of Ernst & Young LLP.

The author wishes to thank Edward Robbins and Keith Bucich for their input on a draft of this article. The opinions expressed are those of the author.

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END NOTES

1 For an enlightening discussion of the controversies and other background of AG 38, see Christian DesRochers, "X-Rated Reserves: AXXX and XXX," *Taxing Times*, Vol. 4, Issue 1 (February 2008).

2 AG 38, Introduction. Regulation XXX is Model 830 under codification. XXX in turn supports the Standard Valuation Law (SVL), which is Model 820.

3 AG 38, Introduction.

4 "NAIC statement regarding adoption of RMORSA Model Act and revisions to AG 38," Sept. 12, 2012, at *http://www.naic.org/Releases/2012_docs/naic_statement_adoption_rmorsa_model_act_ag38.htm*, accessed Nov. 4, 2012. The revised guideline may be found at *http://www.naic.org/documents/committees_jt_ae_ag38_prop_revisions_adopted_a_e_120906.pdf*, accessed Nov. 4, 2012.

5 PBR is not yet in effect for life insurance products, but the relevant AG 38 component is subject to the deterministic reserve requirements in VM-20 of the Valuation Manual that was adopted by the Life Insurance and Annuities (A) Committee on Aug. 17, 2012 (AG 38, Section 8D.a.2). See also American Academy of Actuaries, Life Insurance Issues: Alert No. 2012-L-8, "NAIC's Life Insurance Committee Adopts Valuation Manual," Aug. 17, 2012.

6 IRC Section 807(d)(3)(B)(i). All code references are to the Internal Revenue Code of 1986, as amended.

7 XXX Section 7A(1)(a).

8 XXX Section 7A(1)(b).

9 AG 38, Effective Date.

10 This is necessarily an abbreviated description to explain the general concepts underlying the Example 8 approach. See AG 38 for the full description of the method and its variations under 8A through 8E. This presentation of the "corridor" concept in steps 6 and 8 is similar to that provided by Edward Robbins and Richard Bush in *U.S. Tax Reserves for Life Insurers* (Society of Actuaries 2006) at 284.

11 AG 38 Section 8E introduces new methods for handling a negative funding ratio.

12 XXX Section 7D(2).

13 XXX Section 7A(4).

14 Question and answer 53 of the American Academy of Actuaries XXX Practice Note (December 2006 update) states: "The minimum premiums are typically calculated for each policy year. For a shadow account design this would be the minimum premium required to carry the shadow account from one anniversary to the next."

15 It is actually the *slope* rather than the absolute level of charges that determines the level of reserves. Therefore, it is possible that the reverse is true: that the use of the less favorable rates may have produced a *higher* XXX_{7B} reserve at a particular date. (See SVL Section 5A, which defines the modified net premium to be equal to a uniform percentage of gross premiums.)

16 Life Actuarial (A) Task Force: Statement on Actuarial Guideline XXXVIII, *http://www.naic.org/documents/committees_e_emerging_actuarial_issues_wg_related_ag38_final.pdf*, accessed Dec. 11, 2012; emphasis in original. The ACLI vehemently opposed an earlier exposure draft in an Oct. 19, 2011, comment letter, but LATF adopted the statement essentially as exposed. For more on these exchanges and on varying positions surrounding the treatment and relevance of the $0 to $0 rule, see Keith Bucich, "AG38 Update," *THE FINANCIAL REPORTER* Issue 89 (June 2012) at 14.

17 LATF Statement, *supra* note 16. "[Reserves that use the higher scale of minimum premiums] do not properly reflect the full benefits of the secondary guarantee as required by the law, regulation and guideline."

18 AG 38 goes on to state: "Policy designs which are created to simply disguise those guarantees or exploit a perceived loophole must be reserved in a manner similar to more typical designs with similar guarantees" (AG 38 Introduction, which had no substantive changes in the recent round of revisions).

19 LATF Statement, *supra* note 16. LATF did, however, proceed with clarification of the requirements, working out the various elaborations and safeguards now contained in Sections 8D and 8E.

20 That is, ULSG policies subject to XXX that were issued July 1, 2005, through Dec. 31, 2012, and which contain multiple sets of charges and credits related to secondary guarantees. Section 8D also exempts:
- Policies for which reserves already use the lowest minimum guaranteed premiums,
- Companies whose relevant ULSG blocks do not meet certain materiality thresholds, and
- Companies that file for and receive an exemption from the domiciliary regulator and FAWG.

21 AG 38, flush language preceding Section 1.

22 The FPR would still need to exclude deficiency reserves and be adjusted to reflect the appropriate tax-basis mortality table and interest rates.

23 See Peter Winslow, "The Sixth Circuit Gets It Right in *American Financial*—An Actuarial Guideline Can Apply to Prior Contracts When the Interpretation Was a Permissible Option at the Time the Contract Was Issued," *Taxing Times* Vol. 8, Issue 3 (FEBRUARY 2013) at 7, and Richard N. Bush, "IRS Rules on *American Financial*," *Taxing Times* Vol. 6, Issue 3 (September 2010) at 10.

24 See, for example, "Actuary/Tax Attorney Dialogue on Selected Tax Issues in Principle-Based Reserves (Part IV)" in this issue of *Taxing Times* at 50.

25 American Academy of Actuaries, Life Insurance Issues: Alert No. 2012-L-11, "NAIC Creates Working Group to Provide Guidance on Actuarial Guideline 38," Nov. 1, 2012.

26 For additional perspective on the types of tax considerations involved in XXX financing, see Seth L. Rosen and Arthur C. Schneider, "XXX Reserve Funding is Debt for Federal Tax Purposes," *TAXING TIMES* Vol. 5, Issue 3 (September 2009).