



SOCIETY OF ACTUARIES

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AG38 Update

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In late 2010, the New York State Insurance Department questioned the reserving practices of some companies with universal life products that have a no lapse guarantee. The New York State Insurance Department had concerns with the method used by companies for determining gross premiums for shadow account no lapse guarantees for the purpose of computing reserves. The New York State Insurance Department had meetings with companies over the following months to gain a better understanding of how these companies were determining reserves for their shadow account universal life products. The New York State Insurance Department observed that some companies were using gross premiums in the reserve calculations that were higher than the gross premiums a policyholder would be required to pay to keep the policy in force. In September 2011, the Life Actuarial Task Force (LATF) of the NAIC circulated a letter for comment suggesting Actuarial Guideline 38 (AG38) was being misapplied, specifically in the area of the determination of gross premiums being used for reserves. Given the significance of the financial impact of using lower gross premiums in reserves and a lack of consensus among state insurance departments, an NAIC joint working group was established to address the issue.

JOINT WORKING GROUP

The Joint Working Group of the Life Insurance and Annuities Committee and the Financial Condition Committee (Joint Working Group) was created to address the issues surrounding reserving for universal life products with no lapse guarantees. The reserving practice first identified by the New York State Insurance Department was found to exist throughout the industry and the Joint Working Group was tasked with developing an approach for reserving that would

1) satisfy the industry's concern that LATF's interpretation of Valuation of Life Insurance Policies Model Regulation (Regulation XXX) and AG38 produces overly conservative reserves, and 2) satisfy regulator concerns that reserves for products with a no lapse guarantee are inadequate.

The approach put forward by the Joint Working Group is to have one set of valuation requirements for in-force business and a different set of requirements for new business. The requirement for in force is for companies to continue to use their current statutory reserving approach subject to standalone asset adequacy testing. The asset adequacy testing requirements could differ from the asset adequacy testing requirement in AG38 as it could apply to all issue years subject to Regulation XXX/AG38 and the testing could be subject to additional rules and oversight.

The requirement for new business would be to hold reserves subject to the LATF interpretation of Regulation XXX/AG38, with possible refinements to address what are viewed as overly conservative provisions. The cutoff date that decides which business is new business has not been decided, but business sold prior to finalization of the approach will likely be part of the in force block. It is expected that reserves will eventually be determined by principle-based methods, which could be made retroactive to some universal life no lapse guarantee business.

AG38 CONTROVERSY

The current AG38 controversy involves the gross premiums that are used to calculate reserves. The determination of gross premiums is also a Regulation XXX issue because these gross premiums (also referred to as specified premiums) are used to calculate the Regulation XXX Section 7B (base) and Section 7C (deficiency) reserves that are used in AG38. In general, the higher the gross premiums used for reserves, the lower the likelihood of deficiency reserves. LATF has objected to the practices of some companies when determining gross premiums for reserves when the gross premiums are higher than the gross premiums a policyholder would need to pay to satisfy the conditions of the no lapse guarantee.

The current AG38 controversy involves the gross premiums that are used to calculate reserves.

The concept of a specified premium was first introduced in Regulation XXX, which states that specified premiums are to be used for gross premiums when calculating reserves for policies with a specified premium no lapse guarantee. Regulation XXX does not say how specified premiums are to be determined, only that the “smallest specified premium” be used. AG38 clarifies that shadow account type no lapse guarantees are specified premium type no lapse guarantees by saying that the “minimum gross premiums (determined at issue) that will satisfy the secondary guarantee requirement” are the specified premiums to be used in the Regulation XXX items used in AG38.

A common method of determining specified premiums is to calculate the minimum amount a policyholder must pay in a year such that the no lapse guarantee provision is satisfied for that year. For a shadow account product with increasing cost of insurance schedules, this will result in an increasing scale of specified premiums. It is important to note that this method is not prescribed in Regulation XXX or AG38, but appears to be common practice for calculating specified premiums for no lapse guarantee products that do not have an explicit no lapse guarantee premium requirement. Although Regulation XXX describes a method for calculating premiums such that the *account value* is 0 at the end of each year (Regulation XXX Section 7A4), this is in conjunction with a different type of secondary guarantee in which there are cost of insurance guarantees that could result in a one year gross premium that is less than the one year valuation net premium. For policies with this type of secondary guarantee, this series of one year minimum premiums that results in 0 account value at the end of the year are used as gross premiums for reserves. Although this premium calculation method is not directed at policies with a specified premium type secondary guarantee, it is a commonly used method for determining specified premiums for policies with a no lapse guarantee.

The distinction between this method being common practice on the one hand, but not prescribed by Regulation XXX or AG38 on the other, is important as some companies have designed their no lapse guarantees to result in higher specified premiums when the



shadow account is 0 at the start of a policy year. This is usually done by having a condition where a higher shadow account cost of insurance charge is applied in the following year if the ending shadow account value from the previous year is 0. These higher shadow account cost of insurance charges are designed to produce specified premiums that do not create Regulation XXX segment breaks and are always higher than valuation net premiums (to avoid deficiency reserves).

This practice has been described by some as exploiting a loophole. This would be accurate if this method for calculating specified premiums was applicable to policies with a specified premium no lapse guarantee. In contrast, an earlier controversy involving products that charged a higher shadow account premium load on premiums in excess of a certain amount to reduce the AG38 funding did exploit a loophole as companies were explicitly following AG38 when determining the

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single premium to satisfy the remaining no lapse guarantee. The wording in AG38 was later revised to close this loophole.

The fact that the premium method used by most companies to calculate specified premiums is not an explicit requirement of Regulation XXX or AG38 is likely news to some companies. This also makes it harder to defend their current reserving practice by saying they are following the letter of AG38. Perhaps Regulation XXX/AG38 could have contained an explicit formula for calculating specified premiums instead of conditions that the “smallest specified premiums” or “minimum gross premiums” be used. Companies elected to focus on what was presumably believed to be a prescribed methodology for calculating specified premiums and not on the more general requirements. LATF’s concerns do not appear to be with the general specified premium methodology, but rather that the specified premiums used to calculate reserves are not consistent with the guarantees in the policy.

NEXT STEPS

The proposed bifurcated approach for in force and new business is a compromise between those who believe 1) companies should be holding reserves consistent with the letter and intent of Regulation XXX/AG38, and 2) holding the LATF Regulation XXX/AG38 reserves would impose too high a financial burden on companies. Both groups generally agree that the LATF Regulation XXX/AG38 reserves are conservative and holding lower reserves does not necessarily present a solvency risk

As the final reserving regulations for these products are being agreed, companies with shadow account type no lapse guarantee products are likely investigating alternative product offerings, in the case the ultimate reserve requirements result in a product that is not sufficiently profitable. This is another example of how the regulatory environment influences insurance companies’ product offerings. ■

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