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Regulatory Debate (Part 1): Universal Versus Whole Life

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Moderator: ELINOR FRIEDMAN

Panelists: JEFFREY M. DUBE
ELINOR FRIEDMAN
DAVID J. HIPPEN
DAVID W. SIMBRO
MICHAEL SCOTT SMITH

Summary: The NAIC has introduced many regulations over the past year and is proposing several more that may materially impact life product reserving cash values. Some may result in narrowing the price gap between universal life and whole life plans. Industry experts and participants discuss and debate the necessity for these regulations, the issues surrounding them and their impact on product design. The first session in this two-part series focuses on Guidelines XYZ and AXXX and their impact on universal life plans with secondary guarantees versus traditional whole life plans. Attendees gain an understanding of the upcoming regulatory changes and how they may impact the product and pricing in the future. Follow-up session is 148IF.

MS. ELINOR FRIEDMAN: My name is Elinor Friedman, and I will be the moderator and timekeeper for this session. I'm a consultant with the St. Louis Tillinghast office. Since starting at Tillinghast about two years ago, I worked on numerous life development projects, as well as other types of assignments, including analyzing reinsurance solutions and embedded value reviews. Prior to joining Tillinghast, I worked in the product development area of General American and also in the financial markets group at RGA.

There are some proposed changes to regulations that could materially impact the requirements for cash values and reserves in certain life products, and these

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changes may also alter the current relationship between universal life and whole life products. This session focuses specifically on two changes: proposed Model Regulation XYZ and actuarial Guideline AXXX.

We'll start with the regulatory perspective, and then we'll debate Regulation XYZ and actuarial Guideline AXXX in turn. The debate will begin with an overview, followed by the case for and then the case against, and then we should have about 10 minutes for rebuttal among our debaters. We will at that time also invite the audience to pose questions and make brief comments.

To preserve the flow of this debate, I will introduce the panel to you. David Hippen will provide the regulatory perspective. He has more than 25 years of experience as an actuary and has worked for both mutual and stock life insurance companies. He has performed pricing, compliance and valuation work, and he also has more than 10 years of experience in regulation, working for several insurance departments. Mr. Hippen has worked on several Academy and Society task forces, and he has also taught insurance courses at two universities. He currently works for the Florida Department of Insurance in the life and health rates and forms section.

Jeff Dube will provide the overview of Regulation XYZ and will also present the case against XYZ. He is an actuary in the product development area at MassMutual. He has spent the majority of his 11-year career pricing and coordinating systems for products with long-term secondary guarantees. Mr. Dube is a recent Fellow of the Society of Actuaries and a member of the American Academy of Actuaries, and in 2001 he became very involved in the opposition to XYZ.

David Simbro will present the case for XYZ and the case for AXXX. Mr. Simbro is a vice president and actuary at Northwestern Mutual. In his position he is responsible for the pricing of all of the company's life and annuity products. This includes research and development of new products, annual dividend scale determination, in-force product management and experience studies. Mr. Simbro joined Northwestern Mutual in 1983 as an actuarial student. He is a fellow of the Society of Actuaries and a member of the Academy of Actuaries, and he recently obtained a master of business administration degree from the University of Wisconsin in Milwaukee.

Finally, Mike Smith will present an overview of AXXX, and he will also present the case against AXXX. Mr. Smith is the chief actuarial officer at Lincoln National and is responsible for the actuarial opinion and memoranda, surplus management and asset liability management. Prior to this position, Mr. Smith was responsible for the overall management of Lincoln Financial Group's retirement financial services operation. He has been with Lincoln for more than 14 years, working in reinsurance, corporate and defined contribution lines of business. He's also a fellow of the Society of Actuaries and member of the Academy of Actuaries.

Now, I'll pass the spotlight to David Hippen, who will provide the regulatory perspective.

MR. DAVID J. HIPPEN: The basic function of regulation is to protect companies and consumers. During the last 20 years, there has been a distinct shift in how that responsibility is administered by most regulators. Years ago, the focus was protect the companies, and they will protect the consumers. Now the emphasis is on protecting the consumers and assuming the companies will take care of themselves.

Regulation is supposed to be fair, uniform and consistent. One of the very politically strong arguments often made by companies—and one that commissioners generally listen to—is the need for a level playing field. There are several levels of laws that apply in regulations. Statutes passed by state legislatures are the strongest form. Guidelines used to be simply clarifications that were made by the NAIC and adopted directly by some states and followed by others without formal adoption. Regulations are laws passed or promulgated by insurance departments. They are supposed to be interpretations of statutes; to the extent that they're consistent with those statutes, they are considered to be correct and enforceable law.

Codification has complicated this array of laws to some extent. Much of what has happened under codification has yet to be tested by insurers, regulators and courts, so many questions remain as to how exactly codification affects the law and how it should be administered. Codification, generally speaking, is an effort to take all NAIC models and guidelines and put them into a single handbook so that everybody knows how to follow them. My understanding from the NAIC is that legislatures have uniformly adopted codification.

However, codification includes a caveat that any time the codification principle, practice or provision is in conflict with prior or subsequent state law, the state law takes precedence. What is not clear is codification's effect with respect to previously blank and gray areas. For example, the Universal Life Model Regulation, which virtually the entire industry follows—and, in fact, most states follow—was not actually adopted in the majority of states. However, now that it is part of codification, it may be the law in all states, regardless of whether the state insurance department was using other desk-drawer rules in the interim.

Codification has created a potential set of statutes that could override many blank and gray areas that were unclear before codification. One potential consequence is that when the NAIC creates actuarial guidelines, which become part of the codification manual, the guidelines may have some force of law immediately, even though they previously were viewed as clarifications and were not supposed to be interpretations or new laws. So guidelines might not have the same status that they once did. Further, model regulations might not be as easy to modify as they once were because, if codification incorporates them and legislatures pass codification, state insurance departments may not have authority to modify them, take different positions, or do something else.

XXX was generated because regulators perceived a gap in reserving for term

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insurance. Guideline IV had been explicitly covering products issued with 1958 CSO as the basis. For a period of nearly 10 years, folks were using 1980 CSO products and ignoring the principles of Guideline IV, so regulators saw a need for a substitute. It took another decade for that substitute to be created, as regulators and the industry worked out a compromise from the original principles of Guideline IV. Guideline AXXX seemed necessary to clarify Rule 830 (formerly XXX) because it still seemed that a lot of areas were not clearly covered. If or when AXXX becomes part of the NAIC actuarial guidelines, and part of codification, it may become the law.

The standard valuation law is quite old. Many parts of it are so old that they don't seem to cover a lot of current products, nor is it likely to change rapidly enough to accommodate future new products. Regulators want to administer sufficient laws to protect consumers and maintain a level playing field. We really don't want companies to go under. We want them to at least be able to protect themselves.

Proposed Guideline XYZ, generated by the creation of longer-term secondary guarantees, as they're called in the industry, creates an interesting quandary. The Standard Nonforfeiture Law, which is the statute, used to require that reduced paid up (RPU) or extended term insurance (ETI) be offered on cash-value life insurance. Then, later on it was decided that cash values should be offered if a person didn't want to continue the insurance. But the presumption was the person wanted to continue, and they should have some paid up insurance benefits.

The universal life model, when it was created, had as its apparent main purpose the creation of a commissioners reserve valuation method (CRVM) standard. This was not only so that the states and companies would know what to do for reserves, but also so that there would be a basis upon which universal life reserves could be tax-deductible. Because of this, the universal life model only addressed a small part of nonforfeiture. It controlled front-end loads and surrender charges. It doesn't mention RPU or ETI, smoothness or secondary guarantees. When it was created, the longest secondary guarantees were about one year. If you paid your premium, the policy wouldn't lapse in the first year. Those guarantees have been extended; many secondary guarantees now go to maturity.

The interest of regulators is to protect consumers. The U.S. regulatory community decided a long time ago that consumers should be protected by having a minimum level of cash values for level premium whole life insurance. The whole life product started to evolve with indeterminate premium whole life. Then universal life came on the scene. It was such a radical change that it took some time before regulation really responded. Regulation only responded insofar as the industry wrote a good universal life reserve regulation and tossed in some nonforfeiture, so that was somewhat addressed and put it in place. Many regulators did not understand the universal life model when it was adopted.

With regard to XYZ, the difficulty is that it no longer seems, with those long-term secondary guarantees, that we're regulating universal life the same as we're

regulating whole life. Having been in both fields, I know there are plenty of people in the universal life arena that think that's OK. Regulations in this country are on something of a threshold. Will we continue to require a minimum level of cash values and insurance protection for permanent life insurance, or are we going to follow the international theme and say, "Competition will take care of that to the extent that the consumers want it?" This, I believe, is the substance of the debate: Should we require cash values, or should we not require cash values? Should we let the market determine what those appropriate cash values are?

If you take a whole life product, virtually everybody would agree that regulation requires a specific minimum level of cash values. If you insert in that whole life product the possibility that somebody could pay more premium and get some extra credit for it, that doesn't seem to ruffle very many feathers. If you insert the possibility that paying less than that premium gets you a little bit less cash value, it starts to sound like universal life insurance. A product that has a level premium—and based on that level premium, guarantees a death benefit for life—generates minimum cash values if it's called whole life. Apparently there are some who believe that if it's called universal life, it doesn't have a minimum required level of cash values, even though it's really pretty much the same product with a flexible premium provision tossed into the mix.

As long as there's a secondary guarantee in legal terms, meaning as long as the cash value is positive, many believe that is sufficient, and we shouldn't have to fuss with requiring a specific level of cash value. However, that level of minimum cash values is only regulated insofar as the maximum front-end load and surrender charges. It's not regulated as to levels.

To protect consumers, some folks have postulated that we have progressed to the point that viatical settlements are a worthy substitute for minimum cash values and that regulation should not require any. Is that where we want to go? If that's the direction, the regulators will virtually be compelled to follow as the legislatures change the law.

MR. JEFFREY M. DUBE: XYZ requires policies with secondary guarantees to provide cash surrender values in all years during which the secondary guarantee applies. It applies to both universal life and variable universal life policies and to certificates with secondary guarantees. It applies during the secondary guarantee period only, and for the purposes of XYZ, the secondary guarantee must be greater than 20 years. It's possible that policies that already produced cash values during the secondary guarantee period would be exempt from regulation XYZ.

How does it work? There's really a two-part mechanism to XYZ. The first is a measure of the implied guarantee—that is, the implied mortality guarantee. It says that the present value of secondary guarantee premiums must cover the present value of death benefits and expenses. Using the 1980 CSO, this formula might not add up. XYZ asks you to solve for the mortality basis in such a way that the formula equates. Once you have that solved-for-mortality basis, you use it in a Fackler

accumulation routine to determine the minimum XYZ cash value.

Let's talk about the assumptions that go into that present value formula. The first is the mortality. XYZ calls this the modified mortality rate, and it's a level percentage of the guaranteed mortality charges, the so-called R -value. The R -value is integrated into the present value calculation, so there's no closed-form solution for R ; it requires an iterative solution. An R -value of greater than one implies that premiums already cover mortality and expenses. In other words, your policy is providing cash values in all durations, so when R is greater than one, the policy is exempt from XYZ.

The interest rate used to discount is the guaranteed rate in the contract or, if none is specified, four percent. The secondary guarantee premium is the lowest premium required to satisfy the secondary guarantee. For premium-based guarantee products, for which you need to satisfy the secondary guarantee simply by paying some level of premium, the lowest premium is the level premium that's stated in the contract. For a shadow design, the lowest required premium would be the YRT cost of the shadow grossed-up by any shadow expenses. For the expense allowed, there is a maximum that's stated in the regulation, or you may use the contract guaranteed expense charges. The regulation gives you that choice because by using the contractual guaranteed expenses, you can test to see if your product has an R -value that's greater than one. For the most part, if companies have to put up XYZ cash values, they will use the maximums.

There are two types of maximums: an administrative fee and a premium-based allowance. The administrative fee is the one that's guaranteed in your contract not to exceed \$120. The premium-based allowance in the first year is 125 percent of a level annual premium, plus \$10 per \$1,000, but not to exceed \$60 per \$1,000. This is similar to the standard nonforfeiture maximum expense allowance. There is one key difference. The 125 percent in Standard Nonforfeiture Law uses the net level premium. In this regulation, you use something called the "level annual premium." The level annual premium is simply the arithmetic average of the secondary guaranteed premiums, which is presumably somewhat less than the net level premium. In renewal years you're allowed 20 percent of the level annual premium.

After calculating the implied guarantee, it's time to develop cash values. XYZ allows two methods to develop cash value. First is the prospective method, in which everything is predetermined at issue. You use the same assumptions that you use to calculate R , but you do everything at issue. So you can actually state what your cash values will be at issue. Second is the retrospective method. It also uses the same assumptions as those used to calculate R , except that it uses the actual premiums that are paid into the policy. To the extent that you have money deposited into a separate account on a variable product, you use a blend of the fixed rate and the net investment return. The minimum is net of a few things, such as outstanding policy loans, required premiums that were deferred during the grace period and any required catch-up premium. So to the extent that your policyholder has been underfunding a secondary guarantee—that is, he hasn't been keeping up

with it—and you have a provision that allows him to catch up on a secondary guarantee, you have to offer an XYZ cash value, but you can subtract out the catch-up premium.

In the interest of time, I will skip the assumptions and go right to some of the values. Here's how the cash values might pour out of the regulation.

Year	XYZ with Guaranteed Expenses	XYZ with Maximum Allowable Expenses	Universal Life Insurance Model Regulation
1	15,000	-16,000	-20,000
5	78,000	37,000	33,000
10	162,000	110,000	93,000
20	344,000	268,000	137,000
30	516,000	419,000	0
40	623,000	501,000	0
50	1	1	0

Method based on the 08/09/2002 version of the proposed regulation. Values assume male, age 50, nonsmoker with a level annual secondary guarantee premium of 18,272 payable to age 100. Guaranteed expense charges are 10 percent of premium and a policy fee of \$100 per year. Guaranteed mortality charges are the 1980CSO ANB rates and a guaranteed interest rate of 3%. The surrender charge schedule assumes the maximum SNFL expense allowance in year 1 grading off linearly over 20 years.

The first column is XYZ, using the contract's guaranteed expense assumptions. The second shows the XYZ values using the maximum allowable expenses. You can see that under XYZ in both cases, cash values are produced in all years in a humpback pattern that grades down to \$1 at age 100. On the Universal Life Insurance Model Regulation, cash values run out somewhere between the 20th and 30th year, but notice in the first year you have a hefty negative. That's the effect of the surrender charge of the policy. Jumping back to the first column, if you use the guaranteed expenses in your contract, which are probably somewhat level, they don't necessarily have that high first-year loading in them, and you lose the ability to have that surrender charge-type mechanism. For that reason, you probably use the maximum expense allowance, which is shown in the second column. Again, this allows you to have some sort of a surrender charge mechanism. It's not as great as in the Universal Life Model Regulation, but there is something there.

XYZ is still under development. Instead of the Fackler accumulation of cash values, the latest proposal is to use the mechanism in the Universal Life Insurance Model Regulation with a little bit of a twist. With the mortality basis, you can still use the *R* factor methodology. You can still go through that calculation and use some ratio of your guaranteed cost of insurance rates, or you could use any stated basis used to determine the secondary guarantee. You can state your own mortality basis and expense charge basis. The only two requirements are that those two bases must be disclosed in the contract to the policyholder, and they must satisfy the present value formula. For the prospective formula, the assumptions will still be integrated into the XYZ cash value, and it will still use the Fackler formula.

MR. DAVID W. SIMBRO: I'm sure there are many opinions out there. I just ask that you hear both of us out, and I'll leave it to you to judge how you feel about the merits of the arguments.

I have four things I want to cover. But before I get into that, I just want to make sure in my presentation that I don't miss the boat too much relative to some of the arguments against XYZ. Let me summarize what I think those arguments are, and I'll ask if you're in agreement. Is it fair to say they boil down to the cost of implementing a fix, the lack of any significant profits that are released upon surrender under a typical design, and the fact that you have two parties entering into a contract, and if there's adequate disclosure, what's wrong with that?

MR. DUBE: I'll agree with that. I think you are leading me into a trap here.

MR. HIPPEN: He is leading you into a trap. Let me add an additional argument against XYZ, despite sort of having created the concept. One of the arguments—and for a regulator, a fairly strong argument—against XYZ is that consumers will never need those minimum levels because the universal life contracts will give them cash values in excess of XYZ anyway on a current basis.

MR. SIMBRO: You kind of stole my thunder there. The point I was going to make with those three arguments is somewhat interesting because, if you look back in history, those are the exact same arguments that were made by the industry in the 1850s in terms of why nonforfeiture requirements weren't appropriate. Lo and behold, we have evolved in the industry. We've put in place nonforfeiture requirements, and I think it has served us pretty well. So it's interesting that we're revisiting those same issues.

I have four points I want to cover. One is basic principles of nonforfeiture requirements. Another is the consumer arguments, at least my view of the consumer arguments, in terms of how XYZ benefits them. The third area is the advantages to the industry of having XYZ in place. My final point relates to the strengths of XYZ itself.

In terms of basic nonforfeiture principles, the most fundamental one is that a policyholder should be compensated for the value he gives up on lapse. This doesn't mean they should win upon lapsation, but basic principles of equity dictate that the persisting policy owner should be no better or worse off by the fact that someone decides to persist or not. They shouldn't be at risk for whether or not that occurs. That's been a basic principle of the development of nonforfeiture requirements, and the same issue applies here.

If the future guaranteed death benefit at any moment in time exceeds the future minimum premiums, then there is value there. You may or may not decide to have them, in terms of some nonforfeiture requirements, but the reality, as David alluded to, is that there will be a secondary marketplace that's quite likely to

develop here. I think it's paramount that we understand, in the principles of developing nonforfeiture requirements, that basic calculation exists for any product, and it exists for secondary guaranteed contracts. On a relative level, to the extent there's prefunding in the contract, that should be recognized. If someone's funding on a YRT approach, that creates a very different pattern of value than if someone's funding in a very heavily funded approach. As we'll get into a little bit later, XYZ recognizes that.

Looking at it from the consumer standpoint, the issues are the same as they were in the 1850s. It is not as if zero cash value permanent life insurance is something brand new. This is something we've dealt with before as an industry. From a social standpoint and from the basic principles of equity, it was defined as right and appropriate to provide cash values, and I'm not sure anything has changed on that issue. Another argument from the consumer protection standpoint is that providing cash value puts the consumer's interest in line with the company. Without something like XYZ, the companies frankly will be much better off if someone who paid premiums for 20 or 30 years suddenly lapses, but is that a situation a policyholder should be put in?

A third point gets at the difference between what may be fine and appropriate when I sign on to purchasing the contract at issue and what might happen 40 or 50 years down the road. You have to keep in mind, life insurance is a very long-term deal. Someone signs up for coverage, and his or her personal circumstances or economic circumstances may change dramatically after issue. While they may have felt perfectly comfortable signing up for something with no surrender values, they may not feel so good about that 30 or 40 years down the road. Providing nonforfeiture requirements allows for changing policy owner circumstances.

Related to consumer protection, just think about the scenario that consumers would be in without XYZ being in place. If you take a look at the pricing of these contracts, I think it's fairly common to use a three percent or even four percent ultimate lapse rate. If you look at the most common issue ages, that means you're assuming two-thirds or three-fourths of the buyers are entering into this deal and do not plan to keep it in force. It seems a little convoluted to believe that someone would enter into a deal in which there's no value provided unless they die and that the company's willing to bet on three-fourths of them lapsing. What happens to the consumers if, lo and behold, those lapses don't occur at the rate that the company's anticipating?

From the industry standpoint, there are really two arguments in support of XYZ. One is from a financial angle, and the other is reputation protection in terms of what XYZ can do for the industry. From a financial angle, I look at it as almost fool's gold, betting on lapses to occur in a contract. The policyholder has total control. To understand this risk, I would like to take a look back in time. The Guertin committee report took an in-depth look at nonforfeiture requirements.

Quoting from the report: "Rates of withdrawal are partially at least within the

control of the policy owners and beyond the control or even accurate estimates by companies. Such withdrawals are not contingencies susceptible of actuarial measurement like the contingency of death. Moreover, withdrawal rates in such instances, as they might be called involuntary, are subject to wide fluctuations and to economic influences. It requires no extended demonstration to establish the danger of fixing life insurance premium, so as to make adequacy depend upon a certain number of policy owners withdrawing. If conditions were such as only a small number actually chose to withdraw, the security of the whole body of persisting policy owners would be endangered." The security is, of course, fundamental to the level premium system of life insurance.

I've already alluded to the potential for a secondary market. Some companies are concerned enough about this that they have even tried to modify the assignment provisions in contracts so that the policy owner could not assign the policy to a viatical settlement company. The reality of the secondary market existing is real. I think if you presume that you will get the lapses, what you're counting on is dangerous. You can look at what has happened in Canada or more recently with long-term care companies. A lot of companies in the long-term care marketplace were pricing for seven percent or eight percent or even higher lapse rates. When the long-term lapse rates started coming in at three percent or four percent or five percent, there was significant financial pressure on the companies. Some literally went out of business because of that mistake.

On the flip side, look at the reputation risks to insurance companies. I don't think any of us want to wake up one morning and read this headline in the *Wall Street Journal*. "Ninety-five-year-old forgets to pay one premium after 40 years of paying a level premium and receives no value upon lapse." One bad move such as this can tarnish a reputation earned over a long period of time.

Finally, I want to look at the underlying strengths of XYZ. First, it just bridges the gap that currently exists between the universal life regulation and the standard nonforfeiture law. In addition, as was already alluded to in the outline of XYZ, it does accommodate varying premium patterns. It deals well with things such as the shadow fund approach. Particularly, I think the most recent proposal that Hartford has suggested does a very nice job of accommodating things such as shadow funds. In terms of the level playing field argument, it is consistent with the treatment of other life insurance products. Putting this in place just eliminates any artificial difference that may influence consumers and allows them to look at things fairly and decide what's best for them.

MR. DUBE: I actually will go back into Dave's proposal and rebut while I have the chance. I'll start with basic nonforfeiture principles. The truth is, providing nonforfeiture values is a matter of public policy. It's true that actuarial principles are used to develop the nonforfeiture value, but providing value at all is really a matter of public policy. For instance, in many countries, companies are not required to provide cash value nonforfeiture options. Here in the United States, disability income and long-term care, both products that prefund their risks, do not require a

cash value nonforfeiture settlement. Even the general nonforfeiture project realizes that cash values may not have to be given to policyholders. You only have to disclose to them that they're not going to get anything. Simply put, cash values are not mandated.

Next is consumer protection and the lapse-support issue. Your pricing doesn't necessarily depend on lapse support. It's true that you can price your product to be lapse-supported. I couldn't get away with that in my company. Our financial guys do a pretty good job of reviewing our products, but it's our job as actuaries to make sure we're not supporting lapse-supportive products. As far as potential company actions to encourage lapse, I really don't see how this is an issue on products with secondary guarantees. I agree it's a problem if you don't have the secondary guarantee. For instance, a chief executive officer may realize that he has a large block of business for which all the insureds are more than age 80, and he realizes he will have to start paying claims on that business. Well, he might direct his actuary to increase the costs of insurance or decrease the credited rate so that the cash values are eaten away on those policies, and those policies lapse. When you have a secondary guarantee on those same policies, there's nothing that the company can do to encourage lapse.

I just covered lapse support, so I won't cover it again. The secondary market will always be there. These are minimum values, and the secondary market will most likely provide higher value. So that market will be there anyway. As far as the front page of the Wall Street Journal, again this is something that can happen on any universal life policy. Somebody may be paying their premiums, a lower premium, for 40 years, and they run out of cash. That policy lapses. Secondary guarantee allows you, when you're running out of cash, to continue to pay that low-level premium. If your primary guarantee runs out on a policy without secondary guarantees, you will be forced to pay those high YRT costs.

Finally, in response to the strengths listed, there is also one major weakness with XYZ: it doesn't do what it's supposed to do. By design, shadow products, which use the prospective method, produce zero cash value in all durations. That's because you have a high initial expense allowance in the first year and very low premiums, the YRT premium scale. That YRT premium scale never overcomes that initial expense allowance. With a premium-based design under The Hartford's proposal, you pick your expenses. There's nothing to prevent you from having 100 percent premium load on your product. If you do that, you get zero cash value. The premiums that go into the policy are taken away by your 100 percent premium load. You have it stated in the contract, and it satisfies the present value formula, but it doesn't produce any cash values.

Here are my points. First, the proponents' contention is that these products are really term-to-100 products in disguise, and they should require whole life cash values. The fact is, universal life with secondary guarantees is not whole life and it's not term. Just because the product has the secondary guarantee, a premium that will guarantee coverage, it does not lose its flexible premium nature. Because it's

flexible premium, appropriate cash values are already generated through the Universal Life Insurance Model Regulation. All secondary guarantee does is add no-lapse protection to the existing universal life product.

Second, consumer protection: consumers want this feature. They want long-term coverage for less. These consumers don't care about guaranteed cash values. They're shown an illustration that demonstrates they will not have cash value guarantees in their policies. By forcing guaranteed cash values, one of two things will happen. The cost will go up, or the guarantee will be shortened. Either way, there's also an additional cost for companies to develop their systems to comply with XYZ, reprice and refile their products. All of those costs eventually are passed down to the clients as well. In the extreme case, some may end up without coverage at all. The guy who could afford \$1,000 for lifetime coverage may not be able to afford \$1,200 or \$1,500. So what is his choice? He may end up with no policy at all or one with a shortened guarantee. The bottom line is, consumers should really be given a choice. Why make them pay for something that they don't want or need?

Finally, XYZ is really a lose-lose-lose proposition. Policyholders lose because they'll have higher premiums or shorter guarantees. It's also awfully difficult for them to understand. They'll have no intuitive feel for what this *R* factor means if you go that route, and they'll have no idea how the multiple values work when there are multiple tiers on your product. One of the results of The Hartford proposal is that every guarantee would have to have its own, essentially, surrender charge stated in the policy. It would be almost impossible to explain that to a policyholder.

The industry also loses. There's a large implementation cost associated with this. There are also opportunity costs. Companies will have to spend a lot of time complying with XYZ. The product ideas that they have must be shelved until they can comply with XYZ. The company loses sales and consumers lose out on valuable product ideas.

Finally, as for regulators, there's a split as to whether or not these are actually required. Some regulators have said they will not adopt XYZ if it goes through. This will decrease the uniformity in the NAIC. It's something that they have been working hard to promote. In short, XYZ doesn't work for anyone.

MS. FRIEDMAN: Would you like an opportunity to rebut, David?

MR. SIMBRO: I have just one simple question. I wish I had my Jordan book, because maybe I could find the answer in there. I'm confused by the slide showing that XYZ would require higher premiums. Your statement was that this product is not lapse-supported. I was wondering if you could elaborate on that.

MR. DUBE: Some companies may have a tolerance for lapse-supported products.

MR. SIMBRO: It wouldn't be true for your company?

MR. DUBE: I don't believe so.

MR. HIPPEN: Allow me to toss in an additional regulatory concern. As a regulator, I'm concerned that when I administer the law that, if they get to some other venue, such as a court, somebody will point a finger at me and say, "Hey, you missed something. You didn't do this right." XYZ appears, due to a lot of concerns, to have been pushed into being a proposed model regulation. Its provisions have also been weakened somewhat since the original proposal was made. Many believe that XYZ is not necessary to require minimum cash values under universal life contracts with long-term secondary guarantees. If, in fact, the standard nonforfeiture law would require a level—especially if it were to require a higher level than XYZ—the company and, unfortunately, the regulators may be in a position of having approved practices that are contrary to a statute. The mere fact that it becomes a model regulation obviously doesn't mean that all states will adopt it. If it follows the role model, it's likely that a minority of states will adopt.

However, if a stronger version or that version of cash value requirements appears to be the most consistent and appropriate interpretation of the underlying statute, it may be the law everywhere anyway. So it may be necessary to change the standard nonforfeiture law to avoid an XYZ-type result completely.

MS. FRIEDMAN: I'd like to invite the audience to pose questions or make brief comments.

MR. ARMAND M. DE PALO: As some of you may know, I had a little bit of a hand in both XXX and XYZ, and I'm a strong advocate of both. So I don't want anyone to be confused as to where I stand on this issue. Now, it's clear that when they wrote the nonforfeiture law, regulators expected products with long-term guarantees with meaningful prefunding to have cash values. This issue of no cash values for secondary guarantees was created by a loophole in the Universal Life Regulation, which was interpreting the nonforfeiture law.

The problem with the Universal Life Regulation, more than anything else, was that it tied the expense allowance to what was called the guaranteed maturity premium and not to the premium actually paid. It developed bad practices within the industry of allowing expense charges to be taken in the calculation of universal life that far exceed the premium that was being paid on the contract. That's the fundamental issue that was an oversight in the original drafting of this regulation. In fact, if we went back to that regulation and said, "You can only take 125 percent of the actual premium paid and not 125 percent of a maturity premium that's never been paid," most of this would go away.

Now, XYZ was a compromise developed out of the ACLI committee, where it was clear that if the regulators proceeded—and I think they have sound grounds to proceed—the nonforfeiture law required prospective cash values on all products. That includes universal life. When universal life regulations were written, they never

conceived of a true flexible premium product with no guaranteed premium. Originally universal life was to have a regulation that a guarantee period not exceeding five years would not require any reserves or cash values other than the calculation of the contract. Some companies suggested to the regulators, what if it wasn't exactly five years? Maybe it can be six. The regulators said six or five, that's no big deal. No one ever perceived that someone would take the words "an incidental secondary guarantee" and start extending it to 10, 20, 40, 50 and 100.

People are driving trucks through loopholes in the law, trying to stand behind the word of the law and not the intent. This is what it really will come down to in both XXX and XYZ. If as a profession, we cannot work within the intent of the law, we will always be playing a cat-and-mouse game with regulators: "We found another loophole. Let's close that one." We'll never get to a unified valuation law. We'll never get to the actuary being such a trusted citizen that reasonable assumptions can be made.

XYZ was a compromise that was made by the actuarial committee of the ACLI on the basis that if we must have cash values, this is a reasonable way to go. I want you to understand that what is being proposed is a reasonable set of cash values based on the premium being there. What's happening is that companies that have been using it—and they have been using it for lapse support—don't want to give away what they in effect consider a marketing tool.

This is an important issue. It's only a surrender value that XYZ has; it's not a cash value. It doesn't go into the calculation alone of the actual operations. This argument that it's hard to implement is without merit because when the industry wants something, the cost of implementation is irrelevant. When they don't want something, they argue, "It's flat. We can't do it. We don't have computer systems that can handle it."

MR. THOMAS P. KALMBACH: I am the author of a revision of XYZ, so I actually wrote the proposed revision that's being reviewed right now. The reason I wrote that was to address a lot of the industry concern about large implementation costs. I think today, those who sell universal life have no problems implementing universal life and designing products so that they can be administered simply and implemented with regards to the Universal Life Model Regulation. I find it hard to believe that our industry can't design products that can be implemented inexpensively and follow the old model regulation methodology.

The proposal that I put on the table was very simply the account value minus the surrender charge. The surrender charge is calculated differently and, to the extent that the secondary guarantees don't provide more favorable guarantees than the current charges in the contract, there would be no administrative complexity in implementing that solution. I think for companies that are offering secondary guarantees that are in fact more favorable than the current charges in the contract, there could be some implementation costs. They could continue to sell universal life products in that fashion, but those would be the ones that would be limited to

larger implementation costs.

MS. FRIEDMAN: I think we should move on to our next debate. Mike Smith will start with the overview.

MR. MICHAEL SCOTT SMITH: My task today is a little bit easier than Jeff's. AXXX is done, signed, sealed and delivered, whereas Jeff had to worry about changing his slides at some point. Mine were actually pretty easy to construct. In fact, almost exactly a year ago, I was on a panel at the annual meeting in New Orleans with the regulator and someone else from the industry talking about XXX. We talked about the debate and what these pros and cons were and where this should wind up. I think to be candid, I lost when all was said and done because AXXX was adopted, although there were some modifications that I think made it more fair.

Let me just real quickly talk about AXXX and what it was there for, why it emerged. I'll try to do this in as unbiased and spin-free a way as I can. First of all, the main reason AXXX emerged was to define a guarantee for purposes of XXX. In the minds of regulators, companies were too clever by half in defining when a guarantee did and didn't exist. There were mechanisms put forth that were like guarantees without calling them guarantees. They wanted to close certain loopholes to get closer to a level playing field.

There were also issues that came up relating to flexible premium design, particularly those that involved both catch-up options and prefunding of secondary guarantees. Most important, and I think Armand mentioned this, they were most concerned that by putting forth certain examples, which you'll be able to see in a minute, or by further codifying how to calculate reserves, they were simply inviting, in their minds, more perceived abuse. By putting in more rules, it invites you to walk right up to the line and find out where you are and are not following the rules. It's kind of a perverse result. The more detailed you get in your descriptions, the more it seems to create the opportunity because it would seem to imply at least that people thought about this very carefully and that they laid out a very specific method for a very specific reason. So anything that you can do around that would seem to fit that specific language, would seem to be fair game. There is language in the guideline, and let me tell you as someone whose been to every Life and Health Actuarial Task Force (LHATF) meeting in the last two years, they mean that you're to follow the intent and spirit and not the language of the law. So be forewarned.

The way AXXX is set up is, they put out eight examples. The first six basically define situations in which it was perhaps a borderline question as to whether or not a guarantee existed. They gave these six sample designs, and the idea was to say, "If you do this, this and this, then it is a guarantee." Among the most prevalent examples was an unlikely event governing the premiums. Let's say you had a 10-year guaranteed premium, and then the premium couldn't change in the next 10 unless something unusual happened. The example discussed was Treasury rates falling below two percent. When could that ever happen? The other was refund features that might be triggered if premiums went up. Those were defined as

maybe not guaranteed by some definitions, but AXXX has clarified that those are indeed guarantees.

I would say, maybe surprising to me, that throughout the discussion there really wasn't a lot of controversy about it. Industry raised a few objections. Most of those related to some provisions on reinsurance and particularly how AXXX would affect reinsurers. Those examples were constructed when LHATF did a survey of both industry and regulators and said, "If this happens, is this a guarantee, or how should you treat it under XXX?" While there was not unanimity in that survey, there did seem to be a general movement towards certain answers, which are reflected in AXXX.

Example seven is different, in that it is a clarification of the XXX reserve methodology. In particular it deals with catch-up premium designs. In other words, policyholders might have a specified premium that they have to pay every year, but they also have the right to pay any deficit that they may have accumulated over time. The clarification was that any premium due should be a reduction to your reserves. The only industry objection that came up with this was if the policyholder has to pay a large amount to make the secondary guarantee effective, is there truly a secondary guarantee? Then, by extension, does XXX apply? That argument was made, it didn't have a lot of traction, and so example 7 went on through.

The last one, which is what we're really here to talk about, is example eight. This is commonly called the shadow account provision. I point out to everyone that it's not just shadow account products. It's also specified premium products that allow you to prepay. So if your design allows you to sort of look at the sum of premiums up to a certain point, you have to apply these rules; it's not just shadow accounts.

Example eight defined a nine-step method for these products. This went through a lot of iterations, but it seemed to continue to grow until we finally got to the spirit of a fairly long process, which I'll try to dilute down to the fundamental premise underlying it. On the regulatory front, Sheldon Summers from California was probably the leading advocate of this. He thought that if you fully funded the secondary guarantee, if there's no way that the policy can lapse under the secondary guarantee, then you should hold the net single premium valuation reserve. He started with that premise. Then later we suggested that we should adjust that for surrender charges to create more of an equity situation between that and a regular universal life contract, and so that was added. Then to the extent you fund it less than fully, you hold a proportionate share of the net single premium. That's how it works in a nutshell, and all the nine steps basically deal with whether you call it deficiency or basic reserves and how you give it credit for what you set up via the regular part of XXX.

The one thing about this example that makes it unique, maybe unusual, among guidelines is that part of it is retroactive, but part of it is prospective. The first two steps are deemed retroactive, and then the last seven steps are prospective. You can ask the regulators why they did that, but I think that was a recognition that the

first two steps basically tell you to follow what XXX said, and then the last seven steps are a new method that you couldn't really discern. I'm not sure in my wildest dreams I could have come up with that method of reading XXX. It was sort of a recognition that it was really a change and that, to be fair, it needed to be applied prospectively to give companies a chance to react to that.

MR. SIMBRO: As I think it was already alluded to, the basic premise of AXXX is to do what we can to keep the industry in line with the whole spirit of XXX. There is nothing I'd argue that is unique about AXXX, other than some people have been fairly clever in finding what they perceive to be loopholes in XXX and are driving trucks through them. AXXX is intended to close those loopholes.

I have three arguments I want to go through. One is just the basic principles of reserve requirements. Another is the consumer protection that is provided by AXXX. The final point is some of the strengths of AXXX. In terms of basic principles, first and foremost, reserves exist to provide sufficient assurance that an insurer can meet its obligations. The next three bullets all get at an example I'll try to highlight. If one of you gives me 95 cents, and I tell you that a year later I'll give you a dollar, and if someone else were to give me eight cents a month over that whole year, and I am also to give that person a dollar one year later, in which situation should I be setting aside more money to fund the future obligation? It should be the scenario in which you gave me more money up front. If you compare a YRT approach versus a level premium versus a single premium approach, they should follow the same logical differences in terms of reserves accumulated. I think I have heard at times an argument that if there is more prefunding, the risk goes down, so there should be less of a reserve requirement. It may be true that the risk amount has changed, but in terms of the reserve that should be established, there's higher prefunding, so reserves should be higher.

The final point is just that if the underlying premium patterns are the same for the same level of protection, the reserves should be the same. That gets at the basic point of when you compare two things that to the consumer look an awful lot alike. You can pay a level premium under them, and it will provide a promise of a lifetime death benefit. They should produce similar reserves.

In terms of consumer protection, the first point is that this would increase the likelihood that the assets will actually exist to cover the liabilities. There have been some arguments made that AXXX will raise prices, but I think I would argue that meeting future obligations provides a little more value than the appearance of low prices. The fact that it's low priced at issue doesn't provide a lot of value if the company isn't there to fulfill its obligation.

The final point is that from the financial reporting prospective, there's been an awful lot in the press recently about transparency. We've heard a lot at this seminar about minimum death benefit guarantees and the questions surrounding appropriate reserving requirements for them. I think AXXX will put consumers in a better position to understand the financial strengths of the companies with which

they're doing business.

In terms of the strength of AXXX itself, not to beat a dead horse, but it does close the loopholes in XXX. It also accommodates varying premium patterns. There are varying premiums that can be used for funding the contracts that should translate into varying reserve requirements. AXXX does that. Finally, it makes secondary guarantee products consistent with other life insurance products and removes any artificial difference that may influence consumers' buying decisions.

MR. SMITH: Let me run through the arguments that I've made in the past against AXXX, and then I'll tailor those to the things that Dave said and loop back to any things that don't get covered in his points. First, as I alluded to earlier, guidelines are meant to be interpretations, not new regulations, and there are good reasons for that. I'll talk about that. As adopted, the method produces anomalous results. It's not consistent with the intent of XXX. I'll then talk more about the risk argument and explain what I mean when I say it's not consistent with the risk. It is anticonsumer. Finally I think when Elinor asked me to speak on this, my first thought was, "It's done. Why are we talking about this any more?" I wasn't really planning to come here. I thought it was a good opportunity because in my mind this is illustrative of a problem with our current reserve regime. The formula reserve regime just doesn't work really well for some products, and I think the Academy has recognized that, and LHATF has started to recognize that. We'll talk about that.

Guidelines are interpretations. As I said, steps one and two basically say, "Read XXX and follow it." There's no other way to say it. It is retroactive. The fact that we had to make this prospective is indicative of the fact that this is a change in regulation. Guidelines don't go through the same kind of scrutiny that regulations do. Regulations go through the legislature in most states. They have to pass a higher standard. Guidelines, under codification, are automatic, unless your state issues specific guidance against it. It is worrisome to me to have LHATF basically deciding to change regulations. Then potentially, if you don't get it applied prospectively, that can have very significant and potentially damaging financial implications for your company. I think that was recognized in the process, and I give LHATF a lot of credit for recognizing that. But I still think it is a concern that we're letting guidelines basically take the place of regulations.

As for anomalous results, I think there are problems with the way the method works. Here's the way I like to think of it. If you think of a regular universal life contract without a secondary guarantee as having something like a shadow account, if you will, that basically is a primary guarantee, whatever the interest rate on 1980 CSO. If you apply this method to a universal life contract using those assumptions, you get a different answer than if you apply the universal life model. Now we don't have a level playing field between universal life contracts.

Further, if you just take the guarantee down a little bit, if you guarantee 90 percent of 1980 CSO, which no one would do, you wind up with substantially more reserves

than you do under the universal life model. Again, with the level playing field, when I talk about risk, it's going to be versus other universal life contracts. It's not versus whole life.

Another argument that was made was that XXX wasn't really meant to change the universal life model. It was there to provide a floor on universal life reserves. Conceivably under the universal life model, you could end up with reserves that were under a half or get just down to that. There was an intent, and this came from people who were involved in the XXX construction. So this was contrary to where XXX was going. Again, this was meant to be an interpretation of XXX, and here we are doing something that wasn't consistent with the intent of the drafters.

Here is what I mean by "not consistent with the risk." When you think about a universal life contract without a secondary guarantee that's heavily prefunded, the reserves do go up. Make no mistake. You hold the cash surrender value at a minimum, and they do go up. If you have a universal life contract with a secondary guarantee and it's heavily prefunded, what's the difference between those two contracts from the standpoint of the insurance company? What do they need to fund for? In my mind, the only difference from the insurance company's standpoint is the fact that they may have to pay something on the secondary guarantee down the road. They may have to throw money in, if you will, to the account value to keep it going. If it's heavily prefunded, the chances of that happening are virtually nil. They get really small. Yet as you more heavily prefund it, the difference between what the universal life model produces on a regular contract and what you do on a secondary guarantee just grows and grows, to the point that it may not be economic to offer heavily prefunded contracts with a secondary guarantee. I think that's counterintuitive. Now, that may not be the way statutory formula reserves work, but I think that's just plain wrong. I don't think that's the way it should work. That's the difference, maybe, in our positions. From an economic standpoint and from the standpoint of what the right actuarial reserve is, what makes it sufficient, that's the issue.

As for anticonsumer, I mean it will increase the price of these products, and it will decrease their availability. I don't buy the argument that these things are threatening solvency. I think there's an appointed actuary at every company that has to assess this. We take great pains to make sure we model the secondary guarantees and our products as accurately as we can. Part of my opinion is that the idea that these will create solvency risk is pretty remote, to say the least. That's why we have opinions.

That's about all I need to say on that. Finally, I'll get back to the main reason that I thought this was an interesting discussion. We now have this elaborate nine-step process to calculate reserves on these products. I'm curious to see what innovations our product design actuaries and others can come up with to sort of nibble at the edges of that. That was an argument I raised during the discussion. The more you try to tie this down, the easier it will be to work around it. Then we'll get into long debates about whether or not this is consistent with the intent. To the

extent laws are very specific, then the presumption is, that's the intent. When they're vague, you can get away with saying "Our intent was X." But when they start really getting into the minutia, it's really difficult to make that argument.

I think fundamentally we need to step back and look at the reserve process that we go through. Formula reserves for the products that we sell today are a product of the past, and we don't need them any more.

MR. DE PALO: As some of you may know, I was one of the three who drafted XXX, and XXX was intended as an experiment by regulators to see if the actuarial profession could follow the intent of the law. Some people view the result of actuarial guideline AXXX as a proof that as a profession we failed. We do want to move to a new valuation system that's different from the traditional one. I don't disagree with that point at all. But to move to that, there has to be a sense from the regulators that they can rely on the actuary to follow the intent of the law and not to find loopholes in it.

We ended up with AXXX because people tried to create loopholes. In this case many loopholes weren't even there, but they tried to define them as loopholes. It would have been better not to have actuarial guideline AXXX. I don't disagree with that. We had that because of the actions of maybe a few in the industry—maybe more than a few. If we are to move to a valuation law that is not dependent on rigorous wording of law, we then have to substitute something else that gives assurance to the regulators that the reserves are adequate. Yes, XXX was needed because companies were holding reserves on products at enormous deficiencies in later durations of losses. In fact, prior to XXX, people were reporting enormous profit early in the duration of the product, followed by enormous losses, and that's just inappropriate accounting. This was needed because of the actions of the few.

MR. MICHAEL J. STRECK: I have an observation. First off, I'm opposed to XYZ and probably neutral in AXXX at this point, but I want to take it up to 50,000 feet. When you look at all the churning and Armand's concern that the companies are continuing to look for loopholes, I suspect if you were to call consulting firms and ask them what project they're working on right now, they're probably working on loophole projects. Take that up to 50,000 feet. Why is that happening?

I don't think companies are out there to find loopholes. I think they're responding to market demands and purchasing pressures and opportunities. I view all of the churning really as a very inefficient use of our industry resources right now. I think what we really need to focus on is not the thought of how regulations should have worked in the 1850s, but really in today's environment. What are today's needs, what valuation laws do we need today, and what nonforfeiture laws do we need today? I think a lot of what companies are arguing for within the current regulatory structure is a way to get there with the constraints that we have today. To accuse companies of violating the intent of the law or looking for loopholes, I don't look at it that way. I think companies are trying to meet consumer needs based upon the tools and opportunities available to us in the current environment.

I am concerned that, in the final analysis, the consumer is the one who will take it in the shorts, so to speak. The cost of insurance will go up. Products will be more complex, and I think it's unfortunate. I wish the industry could come together.

My second issue is really more of a question for David from Northwestern Mutual. Let's say we get to the point that the industry is together and working on a new nonforfeiture law. I believe it was Northwestern Mutual's opinion in that arena that all policies should have a guaranteed cash value availability. I think this debate will continue indefinitely into the future until we can find a way to get to common ground. I can't remember what your comment was earlier, but I have the impression that you were pointing back to the original regulations. If we were to change the nonforfeiture law to reflect what the pressures were, I'm not sure Northwestern Mutual would be in favor of that. Is that a true statement in terms of actually making and designing a policy, a structure, in which you could have whole life coverage without required cash value?

MR. SIMBRO: I think we as an industry need to think awfully long and hard about whether that really puts us in a better position if that is what we require. There's a lot of evidence from history that it's a very dangerous situation to be betting on lapsation from pricing. It gets back to that fundamental question.

MR. RICHARD F. LAMBERT: No one really commented about the issue of XYZ applying to variable products. Why should we have guaranteed cash value on variable products? I'd like to hear some pros and cons of that.

MR. HIPPEN: XYZ does apply to variable products. Most companies will use the retrospective method, for which you're using actual premiums that go into the policy. But there is a long, hard fight to remove a strict fixed interest rate from the minimum cash values. The compromise eventually was that, to the extent that assets are deposited in a separate account, you use a weighted average of the fixed account guaranteed rates and the actual net investment return.

There is a perception with any secondary guarantee that appropriate equity involves minimum nonforfeiture values. I think one of the fundamental paradoxes in this debate is that there is a large group of consumers, perhaps growing, that feels that it would rather have the flexibility and would rather not have the controls. They don't care about minimum guarantees. On the other hand, there's still an extremely large group of consumers that is very concerned about guarantees in this country and in any country. You can't have both by regulation. You can't have control and total flexibility at the same time. What will ultimately happen is that there will be a majority that prevails and a minority that is dissatisfied.