AMERICAN ACADEMY *of* ACTUARIES

Report Regarding Revisions to Actuarial Guideline 25
From the American Academy of Actuaries' AG 25 Subgroup

Presented to the National Association of Insurance Commissioners'
Life and Health Actuarial Task Force

Denver, CO – March 2010

The American Academy of Actuaries is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

AG 25 Subgroup of the Nonforfeiture Improvement Work Group

John MacBain, F.S.A., M.A.A.A., Chair

Keith Dall, F.S.A., M.A.A.A.
Barbara Gold, F.S.A., M.A.A.A.
David Hippen, F.S.A., M.A.A.A.
Donna Megregian, F.S.A., M.A.A.A.
Randall Stevenson, A.S.A., M.A.A.A.

Introduction

Pursuant to the January 19, 2010 exposure draft of proposed changes to Actuarial Guideline 25 (AG 25), and based on comments from both industry and regulators recommending that the $10,000 threshold limitation in that Guideline be raised, the Life and Health Actuarial Task Force (LHATF) has requested the American Academy of Actuaries' Nonforfeiture Improvement Work Group (NFIWG) to:

1) Review the background and rationale for the original development of AG 25;
2) Consider the nature of today's pre-need life insurance marketplace;
3) Make recommendations to LHATF regarding the appropriateness of proposed changes to the threshold limitation of AG 25; and
4) Review the consistency of AG 25 (regardless of any changes to the threshold limitation) with the methodology currently under consideration by the NFIWG for revising the Standard Nonforfeiture Law (SNL).

A subgroup of the NFIWG (AG 25 Subgroup) was assembled to prepare this report.

1. Background and Rationale

AG 25 was adopted by LHATF in 1989 and is effective for policies issued on or after January 1, 1991. The guideline interprets both the Standard Nonforfeiture Law (SNL) and Standard Valuation Law (SVL) with respect to the calculation of nonforfeiture values and reserves for policies with death benefits that are adjusted periodically in accordance with the Consumer Price Index (CPI) or another cost of living index according to the terms of the contract. Although not confined to such policies, the guideline primarily affects small amount life insurance policies sold to fund pre-need funeral contracts. Many small and mid-size life insurance companies sell in this market.

Some life insurance policies designed for this purpose provide contractually for increases in the death benefit on a regular basis. Where such increases under the contract are guaranteed, the SNL and SVL are clear that such amounts must be pre-funded for both minimum nonforfeiture and reserve purposes. Where increases under such policies are contractually provided through adjustments via a cost of living index, like the CPI, the nonforfeiture and valuation laws are not definitive. For the remainder of this document, "index" is used to refer to a cost of living index.

Section 5cC of the SNL for individual life insurance addresses "unscheduled changes in benefits or premiums" and indicates that, for policies containing such benefits or premiums, future changes need not be assumed in determining minimum nonforfeiture values. AG 25, in interpreting this provision of the SNL, states that such changes, when prescribed in policies providing for index-based increases and having an initial face amount of $10,000 or less, are "unscheduled" and future death benefit increases need not be considered in determining minimum nonforfeiture values. Such policies having an initial face amount of over $10,000 must have at least a certain minimum level of future death benefit increases assumed in determining minimum nonforfeiture values. In both situations, as actual death benefit increases occur, minimum nonforfeiture values are to be "trued-up" for such increases.

AG 25 recognizes the contractual language incorporating changes due to an index as being "unscheduled," as described in the SNL, provided they are contained in policies having an initial face amount not greater than $10,000. In this case, the language of AG 25 interprets the language of Section 5cC of the SNL as permitting future face amount increases to be disregarded in determining minimum nonforfeiture values. However, AG 25 further requires that, for policies with an initial face amount greater than $10,000, future increases must be considered. In both cases, AG 25 requires a true-up each year to reflect actual increases that have occurred. This interpretation of the nonforfeiture law language therefore permits policies with future benefits contractually tied to an index to comply in a straightforward fashion with IRC 7702 as life insurance, provided the initial face amount does not exceed $10,000. It would appear that LHATF recognized the appropriateness of such policies complying with IRC 7702, while also recognizing that small amount policies have larger expense considerations that justify having lower minimum nonforfeiture benefits, with true-ups occurring as the benefit increases are granted.

For valuation purposes, AG 25 requires that for all such policies some level of prefunding must be considered with respect to future benefits that are contractually tied to changes in an index. It also requires that, as is the case with the minimum nonforfeiture values, reserves be trued-up each year as actual death benefit increases occur.

AG 25 also comments on the implications of policy language providing for increases based on an outside index with regard to the requirements of Section 7702 of the Internal Revenue Code (IRC). The cash value accumulation test contained in IRC 7702 in general does not permit future increases in the policy death benefit to be utilized in satisfying that test. Subsection (e)(2)(C) of IRC 7702 provides a limited "carve out" from this requirement for pre-need insurance products (or policies purchased to cover burial expenses). This carve out permits policies with an initial face amount of $5,000 or less having limited guarantees of future benefit increases to take such limited increases in the death benefit into account in determining the cash value limits under Section 7702. This allows these policies to comply with the cash value accumulation test contained in IRC 7702. However, policies having an initial face amount above $5,000 issued in conjunction with pre-need contracts, and which have guaranteed future increases in death benefits, would not satisfy the carve out under IRC 7702. Consequently they would not likely qualify as life insurance for federal income tax purposes if such future increases in death benefits were required to be taken into account in determining minimum nonforfeiture values.[1]

For policies where future benefit increases are tied to an index, the requirements of AG 25 provide that future death benefit increases need not be considered for minimum nonforfeiture value purposes as long as the initial face amount of the policy is $10,000 or less, thereby permitting these policies to be considered life insurance under IRC 7702, outside of the IRC 7702, Subsection (e)(2)(C), carve out. However, for policies issued with an initial face amount of more than $10,000, the requirements of AG 25 prescribe certain assumptions as to future increases in death benefits for minimum nonforfeiture value purposes. Those requirements could prevent these policies from qualifying as life insurance under IRC 7702.

2. Nature of Today's Pre-Need Life Insurance Marketplace

The nature of the pre-need life insurance marketplace has changed considerably, both since the adoption of IRC 7702 and the adoption of AG 25. Funeral costs have increased substantially since 1991 when AG 25 was first effective. The change in the funeral services component of the All Urban CPI has risen 58% during that period while the All Urban CPI itself has increased 25%. For this market, it is imperative that policies make provision for increases in coverage to

[1] The possibility that such a policy, that is a policy of more than $5,000 which incorporates death benefit increases in the calculation of cash values as of the date of issue, could be designed to comply with Section 7702 cannot be ruled out. However, that is not the focus of this discussion.

permit funeral service providers to make available the promised services at time of need through adequate funding. In addition, some states (e.g., Michigan and Virginia), require coverage increases tied to changes in the CPI (although the law is not clear as to which component CPI must be reflected) to be included in policies sold in conjunction with a pre-need funeral contract. Where a certain level of benefit increase is required to be prefunded, as in AG 25 for policies having an initial face amount of more than $10,000, such policies would most likely not qualify as life insurance under IRC 7702 and, therefore, could create significant tax issues for the issuing company and the policyholder. The relief provided by AG 25 for policies having an initial face amount of not more than $10,000 appears inadequate in this marketplace today in light of significantly increasing final expense costs.

3. The AG 25 Subgroup Recommendations

The AG 25 Subgroup has reviewed the proposed changes to AG 25 and agrees that no changes should be made to the valuation requirements contained therein applicable to policy forms whose contractual language ties future increases in death benefits to changes in an outside index. For valuation purposes, the Subgroup recognizes the appropriateness of prefunding some level of future benefit increases for policies contractually guaranteeing increases tied to an outside index. The issue here is one of company solvency and solidity.

For minimum nonforfeiture purposes, the additional expense component associated with smaller amount policies argues for some relief from requirements to prefund index-related increases for those policies. For situations where such small amount policies are sold outside of the pre-need funeral contract marketplace, the need for increases tied to an outside index would not appear to be a critical aspect of the sale. However, in the case of policies sold in conjunction with a pre-need funeral contract, future increases in death benefits are a critical and in some cases legally required component of the product, since benefits are tied to a promise to provide a certain level of services, the cost of which can increase dramatically during the period from purchase to time of need. In addition, it is important that such policies continue to comply as life insurance under IRC 7702, since the expense and inconvenience of additional tax reporting requirements for non-compliant policies is a significant consideration. For policies containing a guarantee of face amount increases tied to an outside index, compliance with IRC 7702 can best be enabled through the assumption that future increases in death benefits not be assumed for nonforfeiture purposes.

The AG 25 Subgroup is of the opinion that the proposed changes to the nonforfeiture requirements contained in AG 25 are consistent with a reasonable interpretation of section 5cC of the SNL, as well as with the goal of enabling these products to qualify as life insurance under Section 7702 of the IRC.

In addition, the AG 25 Subgroup recommends that the $10,000 limitation contained in AG 25 be updated to reflect changes in the All Urban CPI between January 1, 1991, and the effective date of the change to AG 25. Prospectively, this amount should be increased annually thereafter in accordance with that same index. The Subgroup considers this index more appropriate for this purpose than the increase in the funeral services component of the All Urban CPI, since increases in this latter index component have far outpaced general price increases. Also, it might be unnecessarily excessive to assume that the costs of services provided to purchasers of pre-need contracts have increased as significantly as overall funeral service prices.

The AG 25 Subgroup also recommends that the annual CPI increase be capped (5% per annum is proposed as the maximum) for purposes of determining the increase in the threshold amount up to which no benefit increase assumption is required for minimum nonforfeiture value purposes, since significant short term fluctuations in the All Urban CPI would be inappropriate to apply for this purpose. The Subgroup also recommends that the threshold amount not be increased unless the annual index increase is at least $100.

The Subgroup has attached to this report its proposed revisions to AG 25 and welcomes the opportunity to respond to any questions in this regard.

4. Consistency of AG 25 with Methodology Currently under Consideration for Revising the SNL

The AG 25 Subgroup also reviewed AG 25 with respect to the retrospective approach to the determination of minimum nonforfeiture values currently under consideration by the NFIWG. That approach relates minimum nonforfeiture values to the amount of prefunding in the contract based on the actual policy gross premiums. The current prospective approach incorporated into the standard nonforfeiture value produces minimum nonforfeiture values unrelated to the actual gross premiums for a policy. That methodology relies on anticipated future premiums and on an adjusted premium utilizing those future benefits and the legally prescribed expense allowance.

Under the retrospective approach utilizing actual gross premiums, the amount of prefunding is a function of the fact that policy gross premiums assume some future increases in the policy death benefit as a result of the inclusion of policy language tying future benefits to changes in the CPI. Under such an assumption, the retrospective approach will develop an appropriate amount of prefunding as those future anticipated benefits are funded through a level gross premium. It should also be noted, under the principle-based reserving approach, it would be appropriate to assume future benefit increases for policies with a benefit indexing provision and hence that a reserve adequate to fund those benefit increases should be established.

Under AG 25, which assumes for minimum nonforfeiture value purposes that no prefunding is necessary in the adjusted premium for initial face amounts less than the threshold, it would appear that the retrospective approach under consideration by the NFIWG would produce higher minimum nonforfeiture values (prefunding) since gross premiums incorporate an assumption for future increases.

Draft: 3/5/10

ACTUARIAL GUIDELINE XXV

CALCULATION OF MINIMUM RESERVES AND MINIMUM NONFORFEITURE VALUES FOR POLICIES WITH GUARANTEED INCREASING DEATH BENEFITS BASED ON AN INDEX

A. Valuation - Text

For a policy where premiums are fixed in amount at issue which provides for whole life insurance with the amount of death benefit adjusted periodically with the Consumer Price Index or another cost of living index, the value of the minimum reserve at any time shall be based on the maximum valuation interest rate for the year of issue and an acceptable mortality table for life insurance statutory reserves and based on the death benefit and premium pattern adjusted as provided in the policy by reasonable annual increases based on the index. The present value of future benefits component shall be further adjusted each year by the ratio of the then current amount of death benefit to the initially projected amount of death benefit. If the policy provides for future premiums and such premiums are also adjusted periodically with the Consumer Price Index or another cost of living index, the present value of future premiums component shall likewise be further adjusted each year by the ratio of the then current amount of death benefit to the initially projected amount of death benefit. The assumption as to what is a reasonable annual increase in death benefits based on the index must not be less than the maximum valuation interest rate for the year of issue less:

1. 2.0% If the annual increase is limited to an annual and non-cumulative maximum of 0% through 5.0%

2. 1.5% If the annual increase is limited to an annual and cumulative maximum of 0% through 5.0%.

3. 1.5% If the annual increase is limited to an annual and non-cumulative maximum of 5.01% through 10.0%.

4. 1.25% If the annual increase is limited to an annual and cumulative maximum of 5.01% through 10.0%.

5. 1.0% For all other plans.

The term “annual and non-cumulative maximum” refers to a maximum where each annual increase is limited to the lower of the maximum or the increase in the index without carry forward of excess index increases.

The term “annual and cumulative maximum” refers to a maximum where each annual increase is limited to the lower of the maximum or the increase in the index with carry forward of excess index increases.

In no event shall the assumption as to an annual increase based on the index be less than 1.0%.

This guideline for valuation shall be effective immediately for policies issued on or after January 1, 1991.

B. Nonforfeiture – Text

The threshold amount shall be $10,000 until December 31, 2009. For years beginning ~~A~~after December 31, 2009, the threshold amount for a calendar year shall be the product of $10,000 and the ratio of 1) the index for June of the prior year to 2) 136.0 (the index as of June 30, 1991), rounded to the nearest $25. If this calculation would result in an increase in the threshold amount of less than $100, the unadjusted threshold amount shall continue in effect for the next calendar year. In no calendar year shall the increase in threshold amount exceed 5% of the prior calendar year threshold amount.

The index used to determine the threshold amount for years beginning after December 31, 2009, shall be the Consumer Price Index for All Urban Consumers (CPI-U) as of June 30 of that year. If this index is no longer available, another index which, in the actuary's opinion, reflects the change in general consumer prices for the year should be substituted.

I. FOR POLICIES WHERE ANY DEATH BENEFIT FOR ANY POLICY YEAR WOULD EXCEED ~~$10,000~~THE THRESHOLD AMOUNT EVEN IN ABSENCE OF ANY ANNUAL INCREASES BASED ON THE INDEX

For a policy where premiums are fixed in amount at issue which provides for whole life insurance with the amount of death benefit adjusted periodically with the Consumer Price Index or another cost of living index, the value of the minimum nonforfeiture benefit at any time shall be based on the maximum nonforfeiture interest rate for the year of issue and an acceptable mortality table for life insurance nonforfeiture and based on the death benefit and premium pattern adjusted as provided in the policy by reasonable annual increases based on the index. The present value of future benefits component shall be further adjusted each year by the ratio of the then current amount of death benefit to the initially projected amount of death benefit. If the policy provides for future premiums and such premiums are also adjusted periodically with the Consumer Price Index or another cost of living index, the present value of future premiums component shall likewise be further adjusted each year by the ratio of the then current amount of death benefit to the initially projected amount of death benefit. The assumption as to what is a reasonable annual increase in death benefits based on the index must not be less than the maximum valuation interest rate for the year of issue less:

1. 2.0% If the annual increase is limited to an annual and non-cumulative maximum of 0% through 5.0%.

2. 1.5% If the annual increase is limited to an annual and cumulative maximum of 0% through 5.0%.

3. 1.5% If the annual increase is limited to an annual and non-cumulative maximum of 5.01% through 10.0%.

4. 1.25% If the annual increase is limited to an annual and cumulative maximum of 5.01% through 10.0%.

5. 1.0% For all other plans.

The term "annual and non-cumulative maximum" refers to a maximum where each annual increase is limited to the lower of the maximum or the increase in the index without carry forward of excess index increases.

The term "annual and cumulative maximum" refers to a maximum where each annual increase is limited to the lower of the maximum or the increase in the index with carry forward of excess index increases.

In no event shall the assumption as to an annual increase based on the index be less than 1.0%.

II. FOR POLICIES WHERE ANY DEATH BENEFIT FOR ANY POLICY YEAR WOULD NOT EXCEED ~~$10,000~~THE THRESHOLD AMOUNT IN ABSENCE OF ANY ANNUAL INCREASES BASED ON THE INDEX

For a policy where premiums are fixed in amount at issue which provides for whole life insurance with the amount of death benefit adjusted periodically with the Consumer Price Index or another cost of living index, the unadjusted value of the minimum nonforfeiture benefit at any time shall be based on a level death benefit, an acceptable mortality table for life insurance nonforfeiture and a nonforfeiture interest rate equal to:

1. 4.5% If the annual increase based on the index is limited to a maximum of 0% through 5.0%.

2. 4.25% If the annual increase based on the index is limited to a maximum of 5.01% through 10.0%.

3. 4.0% For all other plans.

The present value of future benefits component shall be further adjusted each year by the ratio of the then current amount of death benefit to the initially projected amount of death benefit. If the policy provides for future premiums and such premiums are also adjusted periodically with the Consumer Price Index or another cost of living index, the present value of future premiums component shall likewise be further adjusted each year by the ratio of the then current amount of death benefit to the initially projected amount of death benefit.

For purposes of this guideline multiple policies on a single life shall be aggregated and only those policies aggregating not more than $10,000 (or the threshold amount[i] after December 31, 2009), shall be considered under II.B.

This guideline for nonforfeiture shall be effective immediately for policies issued on or after January 1, 1991.

BACKGROUND

A number of companies are marketing individual life insurance policies with guaranteed increasing death benefits tied in to a consumer price index or another cost of living index and are for low initial amounts of insurance sold through funeral directors to provide for burial expenses. Some of the policies provide for graded death benefits such as the return of premium with or without interest for the early policy years or for a fixed scheduled increase in death benefits prior to the operation of the index. In some cases there is a maximum on the increase for any year. The vast majority of such policies are single premium policies but some are annual premium policies (generally limited payment). The annual premium may or may not be subject to adjustment with the index.

Since the changes in the index are not known at issue, but from past experience, increases within a given range can be expected with a high probability, it is necessary to assume some increases and then to continually adjust the present value of future benefits component and, if appropriate, the present value of future premiums component in the reserve and nonforfeiture calculation.

Theoretically the same assumed increases in the death benefits should be used for both valuation and nonforfeiture. This guideline so provides for policies where the amount of death benefit in any given policy year would exceed $10,000 (or the threshold amount[1] after December 31, 2009), even if there were no increases based on the index. For practical purposes this may mean that such policies are not marketable for higher amounts as it is most likely that such policies will not qualify under the IRS Section 7702. The cash value accumulation test to qualify thereunder requires a minimum interest rate of 4% and an assumed level amount of death benefits.

In the case of policies for an initial amount of insurance of $5,000 or less, the IRS rules provide an exception to the prohibition of assuming increasing death benefits. However, since many of the policies for very low amounts of initial face amount of insurance would require relatively high expenses if underwritten, many of the policies are issued with simplified underwriting or on a guaranteed issue basis with lower amounts of death benefits in the early policy years, some of the resulting annual increases are such as would disqualify many of the policies for the exception. Therefore it is recommended that policies for low amounts of insurance be allowed to qualify under the cash value accumulation test by permitting the nonforfeiture values to be based on a level death benefit and 4% or higher interest and requiring such values to be updated as increases based on the index take place. The amount in this guideline is set at $10,000 (or the threshold amount[1] after December 31, 2009), to allow for future adjustments and for different patterns of benefits for low amounts.

For single premium policies, the value of nonforfeiture benefits based on a level death benefit and a net assumed nonforfeiture interest rate equal to the maximum nonforfeiture interest rate less an assumed increase based on the index and such factors then adjusted by the projected increases will approximate factors based on assumed increases and the maximum nonforfeiture interest rate. However, the net interest rate is likely to be less than 4%. Thus the procedure of assuming a level death benefit and a net assumed rate of not less than 4% for policies of low amounts of insurance is apt to produce lower cash values than the procedure for large amounts of insurance. Such lower values can be justified based upon the fact that the highly specialized market is prearranged funeral expenses for very small amounts of insurance per policy.

To emphasize the qualification with the IRS rules for the very low amounts of insurance, the nonforfeiture guideline for small amount policies is stated in terms of the net rate, a level death benefit and continual adjustment.

For solvency purposes, reserves should be conservative. The same rules apply for reserve regardless of the size of the policy. That is, lower reserves are not permitted for policies with very low amounts of insurance per policy.

Paragraph 5c(3) of the Model Standard Nonforfeiture Law states that unscheduled changes do not need to be taken into account until the time of the change. The changes guaranteed according to an index are a hybrid, i.e. the changes are scheduled but the amount of the change is not known until the index is determined. Thus the changes must be recognized at issue. This guideline is a hybrid with increases assumed at issue either explicitly or implicitly but with further adjustments made at the time the increase based on the index is determined.

[i] In 2010, the actuarial guideline was modified to substitute a threshold amount for 10,000, such threshold being increased by the change in the CPI-U, the CPI for All Urban Consumers.