ALLIANCE WEBINAR

Recent 7702 and Nonforfeiture Changes: What Fraternal Benefit Societies Can Do and Must Do

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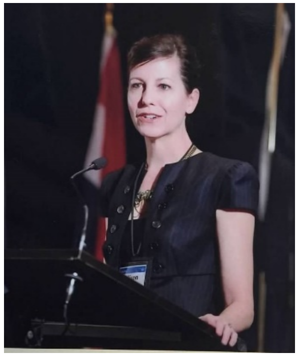

Allison Koppel
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Today's Speakers

Sean Cox, HIA, MHP
President
First Consulting & Administration

Founded in 1969, First Consulting provides **compliance** services for all insurance carriers and related entities. We provide product drafting, state filing, UCAA and TPA licensing, advertising review, and compliance training.

Chris Conklin, FSA, MAAA, MBA
Managing Director
Miller & Newberg Consulting Actuaries

Founded in 1994, Miller Newberg is a full-service **actuarial** consulting firm specializing in the life insurance and annuity marketplace. We serve as the outsourced actuarial department for over 20 life insurance companies and fraternal benefit societies.

Recent 7702 and Nonforfeiture Changes:
What Fraternal Benefit Societies Can Do, and Must Do

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Presentation for the
AMERICAN FRATERNAL ALLIANCE

April 28, 2021

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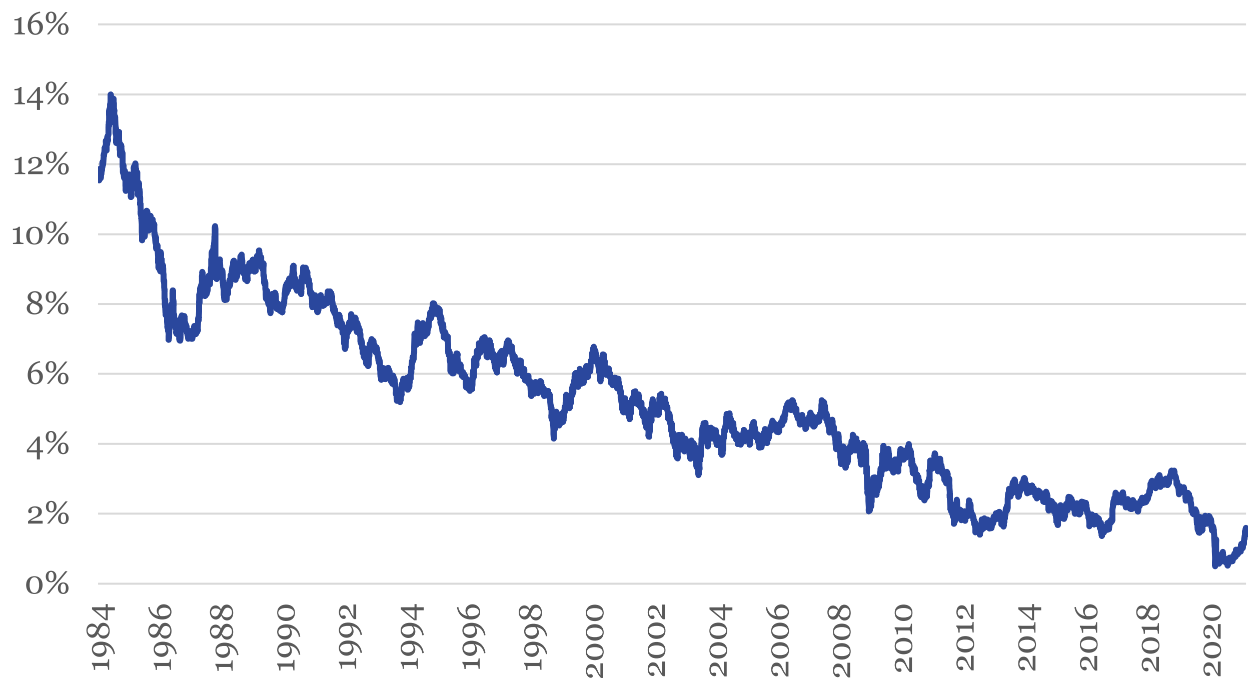
Agenda

- Two regulatory changes as a result of today's low interest rate environment
  - How the Consolidated Appropriations Act, 2021 changed Internal Revenue Code §7702
  - How the NAIC changed minimum standard VM-02 of its Valuation Manual
- Some examples to show the impact of these changes, and how these two changes interact with each other
- Implications for your to-do list
  - What insurers must do: redesign and refile their whole life and term products
  - What insurers can do: opportunities for risk management and product development

Why Changes Were Needed

- §7702 of the Internal Revenue Code and NAIC Standard Nonforfeiture Law for Life Insurance had some minimum interest rates "hard coded" in them, which was becoming problematic
- The changes modernize the rates and remove the hard coding
- Here is the history of the 10-year Treasury Note yield since §7702 was adopted



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§7702 Background Info

- §7702 of the Internal Revenue Code provides standards for what types of contracts receive the favorable tax treatment of life insurance, and which do not

- In essence, it mandates limits on the relationship between a contract's premiums, cash values, and death benefit
  - If a contract's premiums or cash values are too close to the death benefit, the Internal Revenue Code makes it taxed as an investment rather than as life insurance
  - In essence, the insurer must be providing what §7702 considers to be a substantial enough death benefit over and above the premiums and/or cash values to truly be considered life insurance

- Insurers ensure that their contracts meet the standards of §7702

§7702 Background Info

- §7702 defines four calculations:
  - Guideline single premium test
  - Guideline level premium test
  - Cash value accumulation test (CVAT)
  - 7-pay premium test

Pass one or the other to pass the guideline premium test

Pass either the guideline premium test or the CVAT to be considered life insurance

Be considered life insurance and pass the 7-pay test to get the best tax treatment

§7702 Background Info

Tax treatment	Worst	Good	Best
How the contract qualifies	Fails both the guideline premium test and the CVAT	Passes the guideline premium test or the CVAT, but fails the 7-pay test	Passes the guideline premium test or the CVAT, and passes the 7-pay test
What is the contract called	Not life insurance	Life insurance, modified endowment contract (MEC)	Life insurance, not a MEC
Tax-free death benefits	✘	✔	✔
Tax-deferred buildup of cash values	✘	✔	✔
Withdrawals of cost basis first, interest second	✘	✘	✔
Policy loans are not taxable distributions	✘	✘	✔

§7702 Interest Rate Change

- The Consolidated Appropriations Act, 2021, passed by Congress and signed by the President in late December 2020, modifies §7702
- It changes the interest rates used in §7702's four calculated values

<table>
<tr><th>Value</th><th>The interest rate used was …</th><th>The interest rate used now is …</th></tr>
<tr><td>Guideline single premium test</td><td>6%,
Or the interest rate used to compute the contract's guaranteed cash values, if greater</td><td>4%*,
Or the interest rate used to compute the contract's guaranteed cash values, if greater</td></tr>
<tr><td>Guideline level premium test</td><td rowspan="3">4%,
Or the interest rate used to compute the contract's guaranteed cash values, if greater</td><td rowspan="3">2%*,
Or the interest rate used to compute the contract's guaranteed cash values, if greater</td></tr>
<tr><td>CVAT</td></tr>
<tr><td>7-pay test</td></tr>
</table>

* It also provides for these rates to be automatically indexed going forward based upon the lesser of the maximum valuation interest rate for life insurance contracts with guarantee durations of 20 years or longer, or a sixty-month moving average of Federal mid-term rates as defined in Internal Revenue Code section 1274(d)

§7702 Interest Rate Change

- The impact is to allow for higher premiums and higher cash values relative to the contract's death benefit … in recognition of today's low interest rate environment

Nonforfeiture Law Background Info

- Each state has enacted the NAIC Standard Nonforfeiture Law for Life Insurance, which specifies the minimum cash values that must be provided on life insurance contracts
- Minimum standard VM-02 of the NAIC Valuation Manual specifies the interest rate to be used in these minimum cash value calculations

- Prior to the revision to VM-02, the highest interest rate that could be used was:
  - 125% of the statutory valuation interest rate, rounded to the nearer one-quarter of 1%
  - But not less than 4%

- For whole life:
  - 125% of the 3% statutory valuation interest rate is 3.75%, so the second bullet resulted in: Effective January 1, 2022, the interest rate used in a contract's nonforfeiture calculation can be no higher than 4%

Nonforfeiture Law Interest Rate Change

- Effective January 1, 2021, the NAIC revised minimum standard VM-02 to get rid of the hard coded 4% floor and instead refer to the CVAT

- Now, the highest interest rate that can be used is:
  - 125% of the statutory valuation interest rate, rounded to the nearer one-quarter of 1%
  - But not less than the CVAT interest rate specified in §7702 (which, thanks to the recent revisions to §7702, is currently 2%)

- Thus, for whole life:
  - 125% of the 3% statutory valuation interest rate is 3.75%, so the first bullet results in: Effective January 1, 2022, the interest rate used in a contract's nonforfeiture calculation can be no higher than 3.75%

Nonforfeiture Law Interest Rate Change

- The impact is to require higher cash values relative to the contract's death benefit … in recognition of today's low interest rate environment

Instant Poll

- What types of life insurance products does your society currently offer for sale?

  (You may select more than one.)

  - ❑ Whole life
  - ❑ Universal life
  - ❑ Term
  - ❑ None (just annuities and other products)

Impact Example: Single Premium Whole Life

- Let’s do some examples to show how these two changes interact with each other

- With Single Premium Whole Life (SPWL):
  - Insurers typically design their product to comply with the CVAT, which mandates limits around the relationship between the cash value and the death benefit
  - The nonforfeiture law also mandates limits around the relationship between the cash value and the death benefit

- Many SPWL products today use either a 4.5% or a 4% interest rate for their nonforfeiture values and CVAT compliance
- Effective 1/1/2022, they must use an interest rate of 3.75% or lower
  - Note: For SPWL, and all whole life products, a lower nonforfeiture interest rate results in a higher set of cash values

Impact Example: Single Premium Whole Life

- For a $100,000 policy purchased by a male age 45 nonsmoker

Rate Used	4.50%	4%	3.75%	3%
Year 1 cash value	$21,776	$25,362	$27,416	$34,860
Year 20 cash value	$43,500	$47,321	$49,394	$56,344
Ratio	2.0x	1.9x	1.8x	1.6x

- Implications:
  - Insurers' existing SPWL products become noncompliant on 1/1/2022, so by then, insurers must file and gain approval of contracts with lower nonforfeiture interest rates
  - Insurers have choices:
    - Use the 3.75% rate to have low cash values, which helps to minimize premium rates
    - Use the 3% rate to justify higher premiums, to perhaps have higher dividends
  - Thus, an insurer's SPWL products must be redesigned, repriced, and refiled

Impact Example: 10-Pay Whole Life

- With 10-Pay Whole Life (10-pay):
  - Insurers typically design their product to comply with the CVAT, which mandates limits around the relationship between the cash value and the death benefit
    - The nonforfeiture law also mandates limits around the relationship between the cash value and the death benefit
  - But they typically also want to comply with the 7-pay test so that the contract gets the full tax benefits of life insurance and is not considered a modified endowment contract
    - The 7-pay test mandates limits around the relationship between the premium rate and the death benefit

- Many 10-pay products today use either a 4.5% or a 4% interest rate for their nonforfeiture values, CVAT, and 7-pay compliance
- Effective 1/1/2022, they must use an interest rate of 3.75% or lower

Impact Example: 10-Pay Whole Life

- For a $100,000 policy purchased by a male age 45 nonsmoker

Rate Used	4.50%	4%	3.75%	3%
7-pay premium limit	$3,504	$4,031	$4,330	$5,404
Year 20 cash value	$43,500	$47,321	$49,394	$56,344
Ratio	12.4x	11.7x	11.4x	10.4x

- Implications:
  - Insurers' existing 10-pay products become noncompliant on 1/1/2022, so by then, insurers must file and gain approval of contracts with lower nonforfeiture interest rates
  - Insurers have choices:
    - Use the 3.75% rate to have low 7-pay limits and low cash values, to minimize premium rates
    - Use the 3% rate to have higher 7-pay limits and cash values, to perhaps justify higher premium rates and have higher dividends
  - Thus, an insurer's 10-pay and other WL products must be redesigned, repriced, and refiled

Impact Example: Universal Life

- With Universal Life (UL):
  - Unlike whole life, where a lower nonforfeiture interest rate results in a higher set of cash values, with UL, the nonforfeiture interest rate is the minimum rate that the insurer guarantees to credit to the account value
    - Thus, unlike whole life, insurers have been setting this rate well below 4% for quite some time
    - A typical guaranteed minimum credited interest rate on a fixed UL product is 2% and on an indexed UL product is 0%

- Insurers often design UL products to offer customers a choice of the guideline premium test or the CVAT
  - Most fixed UL sales occur with the CVAT, most indexed UL sales occur with the guideline premium test – in other words, both tests get used in UL sales

Impact Example: Universal Life

- The problem that this has caused for insurers is:
  - Under neither of the guideline premium tests could they guarantee customers that coverage would continue for their full lifetime
  - With a high cash value, the death benefit can get forced upwards (per the net single premium/death benefit corridor factors on CVAT policies), which can cause the customer to pay for more insurance than desired
- For a $100,000 policy purchased by a male age 45 nonsmoker, on a UL with a 2% minimum guaranteed interest rate

Law	Prior	New
Guideline single premium limit	$13,513	$24,520
Guideline level premium limit	$1,250	$1,802
7-pay premium limit	$4,031	$7,370
CVAT year 20 corridor factor	2.1x	1.5x

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Impact Example: Universal Life

- Implications:
  - Insurers may not need to file anything new, assuming that they bracketed the net single premium/death benefit corridor factors for the CVAT in their contract filings
  - Insurers will need to update their computer programs and/or factors for computing the guideline and 7-pay premiums and net single premium/death benefit corridors
  - Insurers may want to review their pricing to see if it holds up well after these changes are made
    - High premiums may not be good if they are counting on cost of insurance charges for their profitability, as is common on indexed UL products

Impact Example: Term

- Insurers typically certify in their contract filings that the term product produces no cash values under the nonforfeiture law using a particular interest rate
- If this rate must be lowered, that requires rechecking that no cash values result, and refiling

Implications for Your To-Do List

- What insurers must do:
  - Whole life products: redesign and refile all of their whole life products
  - Universal life products: update their calculations and/or factors, refile if they didn't bracket the CVAT corridor factors in their contract filing
  - Term products: check to confirm no cash values and refile
- What insurers can do: opportunities for risk management and product development on whole life products
  - Design products with an emphasis on higher guaranteed cash values or higher current cash values
  - Design products with an emphasis on high cash values or high death benefits
  - Design products with an emphasis on lower premiums or the ability to accept higher premiums
  - The bottom line: insurers once again have great flexibility in whole life product design!

Instant Poll

- When did you most recently file your life insurance products with the Interstate Compact and/or the states in which you operate?

  - ❑ Within the past few months
  - ❑ Within the past year
  - ❑ At least 1 but less than 5 years ago
  - ❑ 5 years ago or more

Refiling Due To 7702

- Timeline, must be approved and effective by 1/1/22
- Good news, it’s pretty quick and painless
- Many of us just finished making our 2017 CSO filings, but the recency of these filings may also help with your 7702 filings

Refiling Due To 7702

<u>Compact Filings</u> - Recently Approved Filing that is **<u>Less</u> than 90 Days Old**

- Reopen the previously approved filing
- Updated filing to include:
  - amendment fee
  - only the revised pages (if the interest rate wasn't already bracketed)
  - make sure to bracket the interest rate and add to the SOV
  - include revised actuarial memo
- Time to approval: 15 business days
- Filings approved more than 90 days ago will require a new filing

Refiling Due To 7702

<u>Compact Filings</u> – Previous Approved Filing is **<u>More</u> than 90 Days Old**

- Will require a new filing
- Filing to include (if the interest rate WAS previously bracketed):
  - update the Associated Filings area with each of the previously approved SERFF #'s being impacted
  - include revised actuarial memo for each policy
  - likely need to include an updated SOV
- Time to approval: 3-5 weeks

Refiling Due To 7702

<u>Compact Filings</u> – Previous Approved Filing is **<u>More</u> than 90 Days Old**

- Will require a new filing
- Filing to include (if the interest rate was NOT previously bracketed):
  - update the Associated Filings area with each of the previously approved SERFF #'s being impacted
  - only send the revised pages and attach to the Supporting Docs
  - alternatively, you can file an amendment to be used with previously approved Compact products
  - make sure to bracket the interest rate and update the SOV
  - include revised actuarial memo for each policy
  - "Satisfy" the readability requirement with an explanation that the previous readability is not being impacted by this interest rate change
  - statement that the change will only be used for new issues and not in-force policies
  - statement that no other changes have been made
- Time to approval: 3-5 weeks

Refiling Due To 7702

- CA
  - How to file: new filing
  - Special requirements: normal form filing requirements
  - Time to approval: 3 months

- DE
  - How to file: reopen
  - Special requirements: none
  - Time to approval: 1 week to reopen, 2 days to approve

Refiling Due To 7702

- FL
  - How to file: new filing, full policy form unless the interest rate was bracketed
  - Special requirements: normal form filing requirements
  - Time to approval: 2 weeks

- ND
  - How to file: reopen
  - Special requirements: none
  - Time to approval: reopened same day, approved in 1 day

Refiling Due To 7702

- NY
  - How to file: new filing, full policy form
  - Special requirements: normal form filing requirements
  - Time to approval: 1 week

- SD
  - Special process: new filing, revised pages only
  - Special requirements: normal form filing requirements
  - Time to approval: 1 week

Q&A

- Submit your question now
- Or get in touch with one of us later:

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UPCOMING WEB EVENTS

Fraternal Fastpitch – Find a Winning Partner to Help Your Society Succeed!
May 6, 2021 | 1:00 – 3:00 PM CT

Building a Better Board Orientation – Webinar #2 of 3
June 8, 2021 | 10:00 – 11:30 AM CT

Fraternal Sector Orientation For New Society Employees
June 17, 2021 | 10:00 – 10:45 AM CT

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May 6, 2021

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Sonos One
Yeti Tumblers
Authentic Kansas City BBQ Dinner
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Joe's Kansas City Bar-B-Que
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