Actuarial Guideline 49

The Next Chapter

By Timothy Pfeifer
President, Pfeifer Advisory LLC

There has been a lot of attention on Actuarial Guideline 49 (AG 49), adopted in 2015 to guide the sales and in-force illustrations used in presentations of indexed universal life (IUL) contracts. AG 49 introduces many new concepts, and life insurers are still adapting to its requirements. Now the dust has started to settle on some of its provisions and the way carriers will respond. This article reviews the guideline, how companies are taking action, and possible implications for the industry.

What Does It Really Mean?

AG 49 applies to any life insurance product or illustration subject to the NAIC's Illustration Model Regulation and that credits interest linked to the change in one or more external indices. The aim of AG 49 is to foster uniformity among insurers in their IUL illustrations, as well as to reduce buyer confusion and provide clarity for illustration actuaries. The approach to achieving these objectives was to:

1. Define how to establish a maximum credited interest rate for the IUL's Illustrated Scale and earned interest rate for the Disciplined Current Scale *(Effective September 1, 2015)*
2. Control the amount of illustrated policy loan leverage (the difference between the rate credited to borrowed values and the interest rate charged on borrowed amounts) *(Effective March 1, 2016)*
3. Add further disclosures to strengthen customer understanding *(Effective March 1, 2016)*

There is not universal agreement that AG 49 has yet achieved all of these objectives. Has the passage of AG 49 resulted in any change in existing IUL insurers' commitment to the product, either positively or negatively? The answer so far seems to be "no," although some companies seem to have been caught flat-footed and have scrambled to repair what has become a troublesome competitive position. AG 49 shifts the focus (at least somewhat) from illustrated rate to underlying product features and charges, and to many IUL carriers, that levels the playing field.

It also makes sense to ask whether AG 49 will attract more non-IUL insurers into the market. To date, the answer is "no," but it is reasonable to assume that once the smoke clears, additional major insurers will introduce the product, especially if equity market volatility continues. In that vein, there continues to be an active dialogue among the industry, regulators, and consumer advocates. In all likelihood, more requirements and changes related to IUL illustrations are forthcoming.

What Are Companies Doing About It?

The adoption of AG 49 has, not unexpectedly, resulted in some insurers modifying their IUL product designs. The modifications generally attempt to retain illustration competitiveness within the new limitations on illustrated credited rates. Although some insurers have actually introduced such modifications, it is likely that many more will do so in the near future.

Following (in order of most common occurrence) are some design reactions carriers are most likely to focus on.

Persistency Bonuses

AG 49 generally does not limit an insurer's ability to illustrate a persistency bonus. The Guideline does confirm that all bonuses must be reflected in the self-support/lapse support testing. However, a number of insurers have added or enhanced persistency bonuses that begin as early as policy year six, but more typically engage in years 10 to 15. These bonuses can be expressed as a refund of some COI charges, a refund of some expense loads, an additional flat interest rate credit, a multiplier of interest credited, or an increased cap after a specified policy duration.

If the persistency bonuses are operative regardless of the account utilized, they can be illustrated as an addition to the maximum illustrated credited interest. (This is provided the policy form passes the self-support and lapse support tests when the bonuses are accounted for.) Such persistency bonuses could include refunds of loads or additional interest credited rates added to all account values.

If the bonuses apply only to the indexed accounts, the Maximum Illustrated Rate based on the Benchmark Index Account (BIA) would apply. This may limit the amount of bonused indexed interest.

The pricing of persistency bonuses varies across carriers in other ways. For example, some insurers support guaranteed persistency bonuses through products' early year charge structures. In other cases, it appears insurers have decided to lower their effective interest spread — suggesting they either have chosen to accept lower profitability or have changed pricing assumptions or methodologies to maintain profitability. Greater concern among regulators and customers will exist when:

1. Persistency bonuses are not guaranteed.
2. The insurer's sources of recovery for such bonuses are not clear.

This topic remains unsettled among the industry and regulators. Some regulators wish to rework AG 49 (or even the NAIC Illustration Model) to better address persistency bonuses. Some want to discourage the illustration of non-guaranteed bonuses altogether. If such action is taken, a major question is whether it would apply to both IUL and non-indexed UL (since persistency bonuses are also heavily used in most forms of non-indexed UL).

Asset Charges

New charges may appear on IUL contracts going forward in response to AG 49. One type that will likely emerge is a percentage of Account Value charge, which may be levied in all years or only for a specified number of initial years. An asset charge across all IUL accounts would allow for a smaller interest spread and a corresponding higher cap or crediting rate.

However, the Maximum Illustrated Rate may still be limited by the earned rate underlying the Disciplined Current Scale, which cannot exceed 145 percent of the net investment earnings rate of non-hedged general account assets. Thus, using an asset charge solely to boost the Maximum Illustrated Rate may be limited by a combination of AG 49 and NAIC Model Regulation provisions. Further, it may be viewed as "giving from one hand and taking from the other."

More S&P Index Accounts With Non-Zero Floors

AG 49's definition of the BIA dovetails with the S&P 500 Annual Point-to-Point account with a zero floor and a cap. However, if a product does not offer such an account, then AG 49 requires the creation of a hypothetical account, with a cap determined by the actuary to support the company's required spreads and earnings rates. (Little guidance is provided beyond this, enabling actuaries to exercise professional judgment in establishing the hypothetical cap.) One way to do this is to offer an S&P 500 Point-to-Point Account with a non-zero floor.

Multiyear Index Accounts, Non-S&P Accounts, and Participation Rates

It is reasonable to believe that insurers and their actuaries will recognize the freedom afforded to them and elect to develop methodologies that enable competitive Hypothetical Benchmark Index Accounts to be derived and justified. The most probable approaches will be to retain the S&P 500 as the prevalent index, but to design using one or more of the following:

- Non-zero annual floors on index returns
- Participation rates, rather than caps
- Multiple-year interest crediting approaches
- The S&P 500 Total Return Index (that is, the S&P 500 including dividends)
- Monthly sum or monthly average calculations
- Performance trigger crediting approaches

The challenges of using more exotic (or more expensive) indexes in the AG 49 world will likely reduce the use of such accounts — unless the emphasis to selling IUL shifts away from illustrations.

More Simplified Issue

Since AG 49 has reduced insurers' ability to differentiate products in the presentation of future performance, they have searched for other ways to do so. One approach is through the policy underwriting process. Insurers have accelerated the use of technology and electronic databases on IUL applications at higher coverage amounts and older issue ages to shorten the issue process. Such initiatives usually reflect simplified underwriting through age 60 or 65 and up to approximately $500,000 of insurance. In these programs, medical testing is reduced or eliminated. Therefore, companies emphasize a respectable product that can be issued rapidly.

Strengthening Death Benefi Guarantees

AG 49's limitations on IUL sales illustrations may result in more emphasis of IUL contracts as a death protection product. While not likely to compete head-on against true secondary guarantee UL products, IUL will continue its trend of providing longer death benefit guarantees. (Over the last three years, about 20 percent of IUL sales have been associated with longer-term death benefit guarantees.[1]) IUL's competitiveness as a protection-oriented product has also improved, with death benefit guarantees structured as both primary and secondary (no-lapse) guarantees. Still, despite some shifting toward death protection, IUL will continue to compete most heavily as an accumulation and income-generating product.

Policy Loan Features

Starting March 1, 2016, IUL illustrations may not depict a scenario where the interest credited to the loan collateral exceeds the loan interest rate charged by more than 100 basis points (presumably annually). This language was clearly intended to curtail the practice of participating loan leverage in illustrations, in which the rate credited to loan collateral could be 200 to 300 basis points higher than the loan rate charged. Poor index performance, however, could render the actual loan cost substantial.

One response to this AG 49 requirement could be an increase in wash loan provisions, where the loan rate charged and the rate credited to loan collateral are equal (and usually starting at a defined duration). Wash loans are popular with agents and easy to understand.

Spread Death Benefits

To improve illustration performance, one approach requires policyholders to elect (at issue) to take a significant percentage of ultimate death proceeds in an income stream, rather than as a lump sum. The duration of the income stream can be anywhere from five to 30 years. This reduces the mortality costs of the contract, and possibly the product's COIs. It allows the IUL product to compete strongly on the accumulation or income side, with the impact potentially being quite leveraged. AG 49 has no specific standards or limits concerning such a design, although disclosure must be included and clear.

Has the Goal Been Achieved?

Given AG 49's structure and objectives, we need to examine whether consumers are better able to compare IUL products. Given the increase in uniformity in depicting illustrated values for products with accounts defined as BIAs, the answer would have to be "yes." And given the limitations applied across all carriers regarding the maximum amount of loan leverage illustrated, the answer would have to be "yes."

However, we must remember that there are still some gray areas. For example, any cases where a hypothetical account is created are subject to individual company/actuary judgment around methodology and assumptions. This puts prospective customers back into a position of interpretative variations by company. Further, while AG 49 may improve consumers' ability to better understand the relative differences between IUL products, it may not give them a more realistic picture of how any given policy may perform in the future.

A number of carriers report that both agents and prospective customers have begun to focus more on the product's underlying structure, including expense charges, mortality charges, product features, and mechanics. To the extent this takes the focus off of pure illustrated credited rates, it represents a positive impact of AG 49.

Clearly, it was impossible for AG 49 to consider all current and future product directions and actuarial approaches. Some of these "holes" are under discussion after the fact, as regulators and the industry attempt to address remaining open items. Hopefully, efforts to clarify a wider range of IUL illustration topics will succeed in fairly allowing carriers the freedom to accurately portray their policies' performance.

Differentiation and Innovation

While some in the industry have suggested AG 49 will stifle IUL creativity and innovation, this is unlikely — unless one believes the only thing that matters to the marketplace is the product's illustrated credited rate. In fact, just the opposite is likely to happen: IUL products must still be differentiated from each other in the market, despite AG 49's goal of uniformity. Insurers are committed to IUL, and they will continue to seek that differentiation. This means unique features, special underwriting processes, and, yes, new approaches to crediting indexed interest. All carriers' competitive standing depends on ongoing innovation.

Timothy Pfeifer has been active in the financial services industry for more than 34 years. Over the course of his career with Tillinghast and Milliman, Inc., he has been a consultant to life insurance companies, banks, marketing organizations, regulators, mutual fund companies, and settlement companies. In 2008 Pfeifer formed Pfeifer Advisory LLC to focus on strategy and design associated with life insurance and annuity products. He can be reached at tpfeifer@pfeiferadvisory.com.

[1] Based on Pfeifer Advisory LLC's IUL Product Survey results