

Consolidated Appropriations Act, 2021 Impact on Cash Value Life Insurance

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Disclosure

This paper was developed to provide a general overview of the issues related to its subject matter. The comments and recommendations contained in this paper are not intended to provide specific consulting advice or a statement of actuarial opinion. The unique situation of an individual company should always be considered in determining an appropriate response.

Introduction

The revisions to IRC §7702 contained in the Consolidated Appropriations Act, 2021 significantly increase the funding limits under the guideline premium test, significantly increase the amount that can be paid without creating a modified endowment contract (MEC), and significantly reduce the minimum net amount at risk for policies using the cash value accumulation test (CVAT). All these effects are a significant boon to life insurance products designed to optimize cash value accumulation. To take full advantage of these revisions, the policy must have an appropriate guaranteed minimum crediting rate and/or nonforfeiture interest basis.

Revisions

The revisions to IRC §7702 revolve around the replacement of the static interest rates used to calculate the various premiums with a dynamic interest rate that is tied to the current valuation interest rate for life insurance with a guaranteed duration more than twenty years (long duration life insurance valuation rate) and the applicable Federal mid-term rate. Several new terms are introduced to implement this dynamic behavior.

Applicable Accumulation Test Minimum Rate 7702(b)(3): lesser of 4% and the Insurance Interest Rate in effect at the time the contract was issued. *This term defines the interest rate that is used in the calculation of the CVAT net single premium (NSP) rates, the guideline level premium (GLP), and the MEC 7-pay premium limit (MEC 7-Pay).*

Applicable Guideline Premium Minimum Rate 7702(c)(E): Applicable Accumulation Test Minimum Rate plus two percentage points. *This term defines the interest rate that is used to calculate the guideline single premium (GSP).*

Insurance Interest Rate 7702(f)(11)(A): lesser of Section 7702 Valuation Interest Rate for such calendar year and the Section 7702 Applicable Federal Interest Rate for such calendar year. If the calendar year is not an adjustment year, use the most recent adjustment year.

Section 7702 Valuation Interest Rate 7702(f)(11)(B): the prescribed valuation interest rate for life insurance with a guaranteed duration more than twenty years effective in the calendar year immediately preceding such adjustment year.

Section 7702 Applicable Federal Interest Rate 7702(f)(11)(c): the average, rounded to the nearest whole percentage point, of the applicable Federal mid-term rates (as defined in Section 1274(d) but based on annual compounding) effective as of the beginning of each of the calendar month in the most recent 60-month period ending before the second calendar year prior to such adjustment year.

Adjustment Year 7702(f)(11)(D): the calendar year following any calendar year that includes the effective date of a change in the prescribed valuation rate for life insurance with guaranteed durations more than twenty years. *Changes in the interest rate used to calculate premiums under IRC §7702 and §7702A will be triggered by a change in the long duration life insurance valuation rate and will take effect in the year following the change in the long duration life insurance valuation rate.*

Transition Rule

Transition Rule 7702(f)(11)(E): The Insurance Interest Rate will be 2% in the case of any contract issued during the period that begins on January 1, 2021 and ends immediately before the beginning of the first adjustment year that begins after December 31, 2021.

These revisions are effective for contracts issued after December 31, 2020.

Section 7702/7702A Minimum Prescribed Interest Rates:

Premium Value	Issue Year	
	2020	2021
CVAT Net Single Premium	4%	2%
Guideline Level Premium	4%	2%
Guideline Single Premium	6%	4%
MEC 7-Pay Premium Limits	4%	2%

Since the interest rate used cannot be less than the rate or rates guaranteed in the contract, it may be necessary to update individual policy forms to benefit from these changes.

Since the applicable Federal mid-term rate for January 2021 is 0.52% and the long duration life insurance valuation rate is expected to remain at 3% barring a significant increase in interest rates, the Insurance Interest Rate may remain at 2% for several years.

Impact

The following table shows the impact of the lower prescribed minimum interest rates on the guideline and MEC premium limits based on the following hypothetical product specifications:

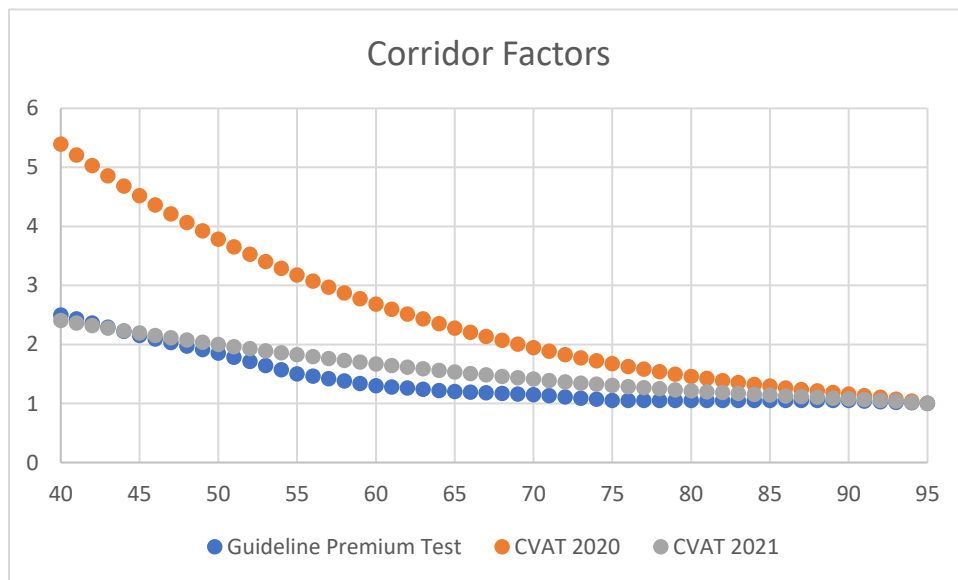
- Guaranteed cost of insurance rates based on the 2017 CSO (F) NS U ALB mortality table
- 2% guaranteed interest crediting rate
- \$5 monthly policy fee and 6% premium load
- \$250,000 face amount
- Deemed maturity at age 95
- The MEC 7-pay limit was calculated based on semi-continuous functions

Issue Age	Issue Year	Guideline Single Premium	Guideline Level Premium		MEC 7-Pay Limit
			Option A	Option B	
35	2020	20,320	1,981	4,000	6,365
	2021	43,479	3,268	7,227	14,518
	Ratio	2.1	1.6	1.8	2.3
45	2020	32,404	3,015	6,061	9,046
	2021	61,058	4,463	9,636	17,477
	Ratio	1.9	1.5	1.6	1.9
55	2020	52,794	4,836	9,472	12,930
	2021	86,173	6,425	13,316	21,103
	Ratio	1.6	1.3	1.4	1.6
65	2020	84,101	8,202	15,356	18,250
	2021	119,593	9,909	19,330	25,421
	Ratio	1.4	1.2	1.3	1.4

The impact of the reduction in the prescribed minimum interest rates is greater at younger issue ages but remains significant at the maximum age tested.

The following chart shows the impact of the lower prescribed minimum interest rates on the CVAT corridor factors based on the following hypothetical product specifications:

- Guaranteed cost of insurance rates based on the 2017 CSO (F) NS U ALB mortality table
- 2% guaranteed interest crediting rate
- Deemed maturity at age 95
- Corridor factors were calculated using curtate functions



While the CVAT corridor factors are still higher than the corridor factors for the guideline premium test for most ages (significantly higher for ages less than 40), the differential in the corridor factors between the two alternative testing procedures has been significantly contracted.

Naturally, the impact of the reduction in the prescribed minimum interest rates for a particular product will depend on its specifications. One of the most important specifications is the guaranteed minimum crediting rate and/or nonforfeiture interest basis. To receive the full benefit of the current prescribed minimum interest rates, the product must have a guaranteed minimum crediting rate and/or nonforfeiture interest basis less than or equal to 2%. This may give universal life insurance products a slight advantage, particularly in the short-term; however, it is not impossible to develop a traditional whole life insurance with a 2% nonforfeiture interest basis.

Response

The reduction in the IRC §7702/7702A prescribed minimum interest rates has significant implications for life insurance products designed to optimize cash value accumulation. Depending on your existing product specifications, some of these benefits can be realized immediately. Other products may require updates before they can benefit from these changes.

Universal Life Insurance

Many universal life products may be eligible for immediate adjustments to the funding limits. If the current guaranteed minimum crediting rate is less than 4%, the guideline and MEC premium limits may be increased and CVAT corridor factors decreased for policies issued beginning on January 1, 2021. Even if the current guaranteed minimum crediting rate is 4%, the guideline single premium may still be increased.

For currently marketed products with guaranteed minimum crediting rates greater than 2% or new product development in 2021, you might consider reducing the guaranteed rate to 2% or less. This will maximize the benefit of the reduction in the IRC §7702/7702A prescribed minimum interest rates and may be prudent given prevailing interest rate markets.

Traditional Whole Life Insurance

Most currently marketed traditional whole life insurance products probably have a nonforfeiture interest basis between 4.0% and 4.5%. To benefit from the reduction in the IRC §7702/7702A prescribed minimum interest rates, it will be necessary to update the nonforfeiture interest basis. Using a basis of 3% will generally allow for an increase in the MEC 7-pay limit without requiring an increase in the reserve. Depending on the specific objectives for the product, it may be worthwhile to consider a nonforfeiture basis between 2 and 3%.

Single premium and short limited-payment products will be significant beneficiaries of these changes. The reduced interest rates should make it possible to develop 10-pay contracts that are not modified endowment contracts and the ability to align the valuation and nonforfeiture interest

rates will significantly reduce surplus strain for single premium products with return of premium cash value benefits.

Trilogy Actuarial Solutions LLC

Let us help you update your portfolio of cash value accumulation products by contacting us for a free initial consultation. You may contact us by phone, email, or through our website. We would be happy to schedule a time to review your situation and collect the information that we need to develop a specific proposal at no expense or obligation to you.

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