EMERGING REVISIONS TO KEY INTEREST RATES TO BE USED FOR LIFE INSURANCE ISSUES BEGINNING 2021

UPDATED DECEMBER 2020, UPON THE PRESIDENT'S SIGNING OF THE CONSOLIDATED APPROPRIATIONS ACT 2021 ON DEC. 27, 2020

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This document was developed for the purpose of providing to its intended audience an overview of items related to the topic of key interest rates used for life insurance calculations, including those for reserving and developing nonforfeiture values, as well as for parameters used in the determination of whether a product meets the criteria for life insurance for federal tax purposes. The comments and recommendations included in this document reflect solely the interpretations and views of its authors, and are not intended to represent formal guidance or instruction. This document has not been sanctioned by, or developed in conjunction with, any actuarial or insurance-related authority, industry organization, or governing body.

EMERGING REVISIONS TO KEY INTEREST RATES TO BE USED FOR LIFE INSURANCE ISSUES BEGINNING 2021 – UPDATED DEC 2020

NOTE: Material changes to this document related to the enactment of the Consolidated Appropriations Act of 2021 (the "Act") are highlighted. Attention is focused on **Section 205 of the Act**, which states that pertinent/applicable provisions outlined therein are effective for all life insurance issued after December 31, 2020. References herein are based on **pages 4923-4927** of the PDF (referenced pages 2456-2460) obtainable via the following link: https://rules.house.gov/sites/democrats.rules.house.gov/files/BILLS-116HR133SA-RCP-116-68.pdf

The purpose of this GBC Whitepaper is to keep you apprised of some developments—both those known and emerging—related to changes to the valuation bases for life policies issued in 2021 and after.

As is widely known, the **mortality tables** to be used for the calculation of reserves and nonforfeiture values for life policies changed to 2017 CSO from 2001 CSO; this was allowed as early as 2017 but required as of 1/1/2020. This change was prescribed/mandated by the Standard Valuation Law, upon the release/adoption of this most-recent incarnation of CSO tables.

However, this change was not accompanied by a revision to the **maximum interest rates** to be used, which are determined by formulas based on long-term trends/indices. The current rates to be used for valuation purposes—3.50% for reserves and 4.50% for nonforfeiture values—were unveiled mid-2012, effective for issues 1/1/13 and after, and have remained unchanged since that time.

Every July, the data used for determining valuation interest rates for all products are reviewed and, if certain criteria are met, re-determined. Re-determination typically happens annually for single and flexible deferred annuities. The applicable rates for life plans, however, utilize 12- and 36- month moving averages of monthly corporate rates, and changes here are less frequent, by design.

As to why this is relevant: the precipitous drop in the monthly corporate rates over the from February to June of this year—from the already low levels seen over the last several years—was enough to trigger a fresh reduction to the valuation rates for life policies.

As things stand right now (December 2020), the rates applicable to life insurance products as of January 1, 2021 are as follows:

- the maximum interest rate used for reserves will be **3.00%** (lowered from 3.50%), and
- the maximum interest rate used for cash values/non forfeiture values is now expected to be **3.75%** (lowered from 4.50%)—note, too, this is lower than the 4.00% rate anticipated over the past several months

In both cases, the lowering of the valuation rates will result in an increase to the reserves and cash values for a given age/gender/risk class/duration/face amount, for a plan issued on or after 1/1/21, versus that of one issued over the past few years.

EMERGING REVISIONS TO KEY INTEREST RATES TO BE USED FOR LIFE INSURANCE ISSUES BEGINNING 2021 – UPDATED DEC 2020 (continued)

As noted, these rate revisions apply to life insurance products issued on-or-after January 1, 2021. However, regarding the nonforfeiture rate change, we offer two additional comments:

- As was the case in 2013, we believe the implementation of the new nonforfeiture rate can be delayed one year (i.e., to apply to 1/1/2022-and-after issues).
- While the current (2020) wording of the valuation manual (specifically VM-02) floors the nonforfeiture rate at 4% —intended to coincide with the rate cited in Internal Revenue Code Sec. 7702, as used to define life insurance for federal taxation purposes— changes to the Valuation Manual for 2021 and amendments to Sec. 7702 contained in the Act (both discussed in more detail below) combine to produce a new, lower floor, which allows for a nonforfeiture rate of 3.75% (i.e., lower than 4%, producing even higher cash/nonforfeiture values).

Below is an overview of far reaching **legislative and regulatory changes** which will impact nonforfeiture rates—as well as the entire life insurance landscape—in 2021.

ITEM 1 – Changes to the Valuation Manual applicable to Life Insurance

The NAIC's Life Actuarial Task Force (LATF) approved a modification for the 2021 Valuation Manual, changing the reference which sets the floor to the nonforfeiture interest rate (VM-02, Sec. 3.A.).

The 2020 Valuation Manual states straightforwardly that the rate "shall not be less than 4%." However, the new VM reference instead cites the floor as being the interest rate used for the Cash Value Accumulation Test in IRC S. 7702… which, prior to the Act, happened to also be 4%.

ITEM 2 – Changes to the Internal Revenue Code applicable to Life Insurance, based on provisions within the Act

The language of the Act appears to be similar to that contained in Section 40308 of H.R. 6800 (HEROES Act, originally passed by the U.S. House on 5/15/2020) which modifies the effective rates in IRC S. 7702; that is, those be used in the two methods for defining a contract as life insurance for federal tax purposes. Specifically:

- the rate used in the Cash Value Accumulation Test (4.00%, prior to the Act), and
- the rates used in the Guideline Premium Tests, both Guideline Level (4.00%, prior to the Act) and Guideline Single (6.00%, prior to the Act)

[Note: by extension, the 4.00% rate cited in S. 7702A for developing the 7-Pay premium (i.e., MEC testing) is affected as well.]

The amendments in the Act effectively replace these rates with floating/indexed rates determined by formula, with the current/pre-Act rates (i.e., 4%, 6%) acting now as caps/maximums. Furthermore, the rates will not be fixed—as they have been for 30+ years—but can change more frequently, based on triggering criteria.

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Though published in June, we believe the following article contains information still applicable to the language of the Act as passed/enacted:
https://sections.soa.org/publication/?m=59625&i=664796&view=articleBrowser&article_id=3705178

We won't go into the detail here as to how the new/replacement rates are determined, but our interpretation of the provisions in the Act indicates that the S. 7702/7702A rates would reduce from 4.00% and 6.00%, respectively, to **2.00%** and **4.00%**, for 2021, and would thus be applicable to all policies issued after January 1.

As noted earlier, these changes—particularly Item 2—have far-reaching ramifications and consequences, not just regarding currently developed products, but also to the design/profitability of future ones.

[For clarification: Because the S. 7702 rates are being *lowered*, it would not appear to be the case that currently developed products would not qualify as life insurance under federal tax definitions when issued in 2021 (as the threshold or "ceiling" for value accumulation is being *raised* with this change).]

Of immediate concern, these changes would lower the "floor" of the nonforfeiture rate (from 4.00% to 2.00%), meaning the nonforfeiture rate noted previously for 2021 (and assuming implementation can be delayed until 2022) would be **3.75%** rather than 4.00%.

As of yet, there is very little by way of obtainable industry guidance (e.g., via the NAIC, ACLI, etc.) on this matter, so we welcome input from these and other players.

However, due to the relatively sudden emergence of the most recent changes—and their proximity to the date by which they are affective—we feel it is imperative we share this information with our clients. We will continue to monitor this emerging situation, and keep you timely apprised of any updates/guidance we receive.

In the meantime, the "takeaway" from this updated Whitepaper should be that, unless there is sudden push from major industry players (NAIC, ACLI, etc.) to somehow delay or override the anticipated changes—and we have seen no such action in this direction, to date—companies should expect that:

- ➔ the new reserving rate for 2021 issues will be 3.00%,
- ➔ the nonforfeiture rate for no-later-than 2022 issues will be 3.75%, rather than the 4.00% anticipated by most of the industry prior to the rapidly unfolding events of the past few weeks, and
- ➔ the key interest rates which impact the definition and taxability of life insurance are expected (based on our interpretation of the amendments to S. 7702) to fall by 2.0% for 2021 issues: the Guideline Single Premium rate reduced from 6.0% to 4.0%, and the Guideline Level Premium and CVAT rates—and, by extension, the S. 7702A 7-Pay premium rate—reduced from 4.0% to 2.0%.

As such, companies should plan accordingly (e.g., informational filings; systems updates—such as illustration and administrative; re-pricing for existing products; potential for new product development, etc.).

Please feel free to reach out to us at Griffith, Ballard & Company about these emerging issues, and we will be glad to discuss planning and strategies, in both the near and mid/longer term.