7702- Insurance Regulations

The life insurance industry obtained some much-needed relief in the recently passed coronavirus relief stimulus package

With an effective date of January 1, 2021, the Consolidated Appropriations Act 2021 (the "ACT") signed by President Trump into law on December 27, 2020 tasks the life insurance industry to move quickly to implement the legislative changes to Internal Revenue Code Section 7702. The ACT changes provide relief to an industry impacted by more than a decade of low interest-rates and further exacerbated by the COVID-19 pandemic. These key life insurance compliance provisions have the potential to be as disruptive (but in a positive way) as the pivot to digital and remote work environments only ten short months ago.

This white paper will examine the following:

- Why is a change to 7702 important?
- What is Section 7702?
- What should we expect?
- What changed?

Why is Change to 7702 important?

The insurance industry has had a standard set of compliance test protocols which has remained fixed for 35+ years. This mathematical relationship, between premium, cash value and death benefit is often called "corridor". The bigger the corridor (pre-ACT state), the more Net Amount At Risk that a life insurance carrier would need to account for from a pricing (Cost of Insurance) and regulatory perspective. The new ACT repositions these tests as a variable standard that is reset each year for all newly issued policies. This immediate reduction in guaranteed rates used calculating tax compliance for either Cash Value Accumulation Test or Guideline Premium Test has multiple positive impacts for both insurer and policyholder alike.

While the cost of compliance testing and analysis may increase marginally, the competitiveness of cash value-based accumulation life insurance products as an asset compared against other financial investments will improve and should more than offset these marginal costs.
All lines of life insurance from whole life to universal life, variable universal life and private placement products will benefit from this change. This change is positive for the industry and bodes well for Corporate-owned and Bank-owned life insurance policies in particular. Suddenly, a company can allocate more money to life insurance investments than under previous regulations.

What should we expect?

The changes to Section 7702 provide an interesting opportunity for the insurance market. While insurers had time to analyze and prepare for the potential change, the likelihood of reform seemed a remote possibility throughout much of 2020. Unlike most insurance regulation reform, which moves at a tortoise's pace, the politics of this regulatory change only provided four calendar days between the passage of the Consolidated Appropriation Act and the effective date of the new compliance regulations.

The next few weeks and months will be a scramble and, to industry insiders, will seem a bit frazzled and harried. Remember, while specific rates for compliance testing coalesce around an industry-wide standard, other regulations are subject to carrier interpretation. Each carrier will be researching and reacting to a myriad of issues and ideas.

Since the historic rates exceed the new minimum rates, carriers can continue to issue policies under the old limits, while analyzing and before adopting the new methodologies. Some carriers will rework and reprice their products to take full advantage of the regulatory change, while for others, a simple pricing modification will suffice. All carriers will be taking some action during 2021 and most will be looking to do something in the short term to take advantage of the opportunity. Overall, carriers may need to evaluate pricing because often other components are built into the Cost Of Insurance (commissions, overhead expenses, etc.). Since they are collecting less dollars (as a result of lower Net Amount At Risk), they may need to change other levers (Cost Of Insurance rates, policy fees, etc.)

The new 7702 rates apply to newly issued policies - compliance testing and evaluation is measured with original contract language at the time the contract is issued. In-force policies remain subject to the original issue test. Some carriers will evaluate whether a face increase to an existing policy results in a "material modification" and availability of the new rates is a better outcome than issuing a new policy. All these considerations are occurring in real-time versus the months of preparation usually associated with regulatory roll-outs. That is why the roll-out may appear to be fragmented and disjointed.

What is Section 7702?

Established in 1984 as part of Deficit Reduction Act, Section 7702 provides for the beneficial tax treatment for life insurance contracts. Congress added cash value accumulation standards for life insurance to the Internal Revenue Code to prevent financial architects from crafting ordinary investment arrangements as tax-favored life insurance policies.
By restricting the investment orientation through premium limitations and/or minimum cash value/death benefit standards, the code established a minimum amount of pure risk in the contract. These restrictions are implemented with Net Single Premiums (NSP), Cash Value CVAT Corridor Factors, 7-Pay Factors and Guideline Premium Limitations. As an actuary friend of mine suggested, "insurance tax compliance is all math!"

No provisions were included to adjust the prescribed interest rate under Section 7702. As such, the following interest rates were defined (hard-coded if you will) and have remained in force since inception of the law:

·NSP, CVAT Corridor Factors, 7-Pay, Deemed Cash Value, Guaranteed Cash Value Factors, and Guideline Level Premium (GLP) - Greater of 4% and guaranteed interest rate
·Guideline Single Premium (GSP) - Greater of 6% and guaranteed interest rate

While the interest rates were defined by regulation, other areas of Section 7702 code are subject to carrier interpretation, resulting in multiple carrier-specific implementations of the compliance calculations across the industry.

What changed?

The new Consolidated Appropriations Act replaced the historic two fixed interest rate benchmarks used in life insurance-related tax and regulatory calculations with variable rates calculated off the "Section 7702 applicable accumulation test minimum rate." This approach better reflects current interest rates and ensures that future evaluations reflect the appropriate economic conditions at the time of policy issue. These new 7702 provisions have an effective date for policies sold on or after January 1, 2021. It allows for a 2% rate to be used for calendar 2021 before the floating rate model becomes effective the following year and beyond.

The following table provides a summary of the key rate changes:

	Code Section	Prior Section 7702 Regulation	New 7702 Regulation
Net Single Premium	7702 (b)(2)(A)	Greater of 4% or rate guaranteed at issue	Greater of Applicable Accumulation Test Minimum Rate or rate guaranteed at issue
Guideline Single Premium	7702(c)(3)(B)(iii)	Greater of 6% or rate guaranteed at issue	Greater of Applicable Guideline Premium Minimum Rate or rate guaranteed at issue
Guideline Level Premium	7702 (c)(4)	Greater of 4% or rate guaranteed at issue	Greater of Applicable Accumulation Test Minimum Rate or rate guaranteed at issue

We anticipate traditional COLI and BOLI carriers to increase capacity as a result of these changes.

Carriers who had previously stopped selling COLI and BOLI products during the low-interest rate period will evaluate a return to market, while others who might have evaluated the COLI market beforehand may now reconsider entering the space.

Andesa is here to help. Please reach out to set up a call to discuss questions or implications with one of our actuaries.