



# What About Those Shadow Accounts?

by James N. Van Elsen, FSA, MAAA

## A REPRINT FROM THE VAN ELSEN REPORT

*{The following is an open letter to Allied Life from James N. Van Elsen. Copies of this newsletter are being sent to all state Insurance Commissioners.}*

There has been much discussion about the treatment, under the new XXX Regulation, of "shadow accounts." "Shadow accounts" are a recent innovation for universal life products. They appear to be an attempt of some companies to avoid the impact on XXX on longer level premium contracts. These accounts were discussed extensively at the fall L&HATF meeting in Atlanta. At that meeting, Jim Van Elsen made a presentation outlining his interpretation of the regulation as it pertains to these accounts. At the request of several regulatory and industry actuaries, the following is a summarization of that presentation.

First, what are "shadow accounts." They are a pseudo-fund in the universal life contract. Premiums are credited to this account in the same manner as the account value. Interest is credited to the fund, although it may not be the same rate as for the account value. In some cases, the guaranteed interest rate may be much greater than the account value. Cost of insurance charges are usually a constant percentage of the valuation mortality rates. Expenses may be considerably less than the account value. An illustrative "shadow account" might guarantee to credit 6%, have cost of insurance rates equal to 50% of 1980 CSO with 20-year selection factors, and have no expenses. The "shadow account" is not available to the policyholder. Its only purpose is to test whether the policy remains inforce. As long as the "shadow account" has a positive value, the policy remains inforce, regardless of the amount remaining in the account value. Companies with these shadow accounts intend to illustrate level premiums that are fully guaranteed under the guarantees of the "shadow account."

What about reserves under XXX? The proponents of this subterfuge would maintain that the minimum premium for secondary guarantees is derived per §7A(4) of the model regulation. This section states: "the minimum premium for any policy year is the premium that, when paid into a policy with a zero account value at the beginning of the policy year, produces a zero account value at the end of the policy year." As such, these companies would maintain that the minimum premium is a YRT-type scale that is a constant percentage of the valuation mortality rates. With the YRT schedule, zero terminal reserves would develop. The constant percentage results in a very long initial segment, allowing the X factor to eliminate the deficiency reserves. The end result is reserves equal to  $\frac{1}{2} c_x$ , the same as before XXX.

### ***In Our Opinion***

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Phone: 515-674-4046

Fax: 515-674-3198

E-Mail Address:

[mail@veconsulting.com](mailto:mail@veconsulting.com)

Mailing Address:

Van Elsen Consulting, Inc.

123 North Walnut

Colfax, Iowa 50054

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There are some fallacies in this argument, however. The first issue is the definition of “account value.” The proponents of “shadow accounts” have taken the liberty to use account value to be the same as “shadow account.” A more reasonable definition is one that defines account values as the basis of accumulating policyholder surrender values. Traditionally, the cash surrender value has been equal to the account value less the surrender charge, if any. To use “account value” as meaning “shadow account” and not the amount used for determining policyholder values is indefensible.

If you can't use §7A(4) to define minimum premiums, what do you use? You must go to §7A(2). Here you find: “When a policy contains more than one secondary guarantee, the minimum reserve shall be the greatest of the respective minimum reserves at that valuation date of each unexpired secondary guarantee, ignoring all other secondary guarantees.”

Multiple guarantees? You won't find them listed in the policy, but it is an easy exercise to derive the premium that would guarantee coverage for one year. Similarly, a premium can be derived for two years of coverage, three years, four years, and so on. Reserves, therefore, would be based on the greatest of the reserves under all the possible premium guarantees under the terms of the “shadow account.”

This attempt to avoid the reach of the XXX Regulation is disappointing. The intent of the regulation is very clear. If you are guaranteeing level premiums, humpback reserves are expected. Anything else is contrary to the intent, if not the letter, of the regulation. This regulation was written by industry personnel, including actuaries from those companies attempting this ruse. How are we to be trusted in the future if we take regulations to the regulators knowing that there is an undisclosed “loophole” that we will take advantage of when the regulation is adopted? I hope that regulators will take an aggressive position in policing compliance with XXX. The companies that are following the intent of the regulation are counting on it.

## Van Elsen Consulting, Inc.

Van Elsen Consulting, Inc. is an actuarial consulting firm. James N. Van Elsen, FSA, MAAA is president and responsible for the work completed. We specialize in serving the needs of smaller life insurance companies.

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- What did your consulting firm do to help solve the impending disaster in the 1999 term market?  
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**Van Elsen Consulting, Inc.** produced an Excel spreadsheet to calculate XXX reserves and provided it to all companies at a very reasonable cost. Many of the industry's top term insurance companies used this spreadsheet to prepare for the 2000 implementation of XXX.
- When did your consulting firm learn how to work with XXX?  
**Van Elsen Consulting, Inc.** has been involved with XXX since 1991. **James N. Van Elsen** was one of the primary brokers of the compromise that allowed the 1999 version of XXX to be adopted by the NAIC. Without this compromise, the industry was faced with uneven adoption of the 1995 version of XXX.

As you consider your valuation actuary needs in the future, consider the following:

- What is your consulting firm doing to help reduce the burden of valuation requirements for smaller companies?  
**Van Elsen Consulting, Inc.** is the **only** consulting firm fighting for more reasonableness in requirements for smaller companies. Many larger consulting firms have held that **all** life insurance companies should be subject to Section 8 opinions (Asset Adequacy Analysis), despite the cost or benefit to their clients.

As you consider your actuarial consulting needs in the future, consider the firm that works hard to reduce the cost of regulation for its clients.

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James N. Van Elsen, FSA, MAAA  
Terry Hilker, LUTCF  
Mike Staudacher  
Beth Ann Van Elsen  
Sarah Ann Van Elsen

