HAMILTON SMITH ASSOCIATES

US Federal Regulatory Impacts on Life Contract Administration Software Sales

Over the last 30 years, regulations have been layered repeatedly into the process of administering US life insurance business. We have reached the crossover stage today where it is easier to administer the collective features of a life insurance contract than it is to support the surrounding and interwoven regulations mandated to accompany a contract. This is especially true of the impact of Section 7702 and 7702A of the Internal Revenue Code.

For 21st Century software providers, the message is clear – US regulations need to be included in the inherent design of any successful US administration software solution and not considered a nuisance add-on task to be treated lightly or dismissed. The one-time sales approach of taking a competitive stance to just "partner with the insurer to get these regulations done somehow after the sale" is becoming the path to losing the sale.

You might think this problem will subside in importance in the future. No so. A recent trend that increases the importance of Federal 7702/7702A compliance is that US Treasury has discovered a lucrative new source of tax revenue – fines and penalties for regulatory non-compliance levied on life insurers. A number of large US insurers have been recently fined for millions of dollars when non-compliance has been revealed through a single audit of a taxpayer, ultimately leading back to the insurer. This process is expected to continue in the future for a revenue starved government. Both carrier funds and marketplace reputation are at stake in this process. For this reason, tax law compliance has moved at many insurers from a tedious back room topic to a new strategic focus topic.

Prior to 1982, life insurance contracts were largely ignored in the US Internal Revenue Code. Due to growing abuses, the Internal Revenue Code was revised multiple times in 1982, 1984, 1986 and 1988 to add new pervasive tax provisions impacting virtually all cash valued life insurance contracts in the US. The goals were twofold:

(1) under Section 7702, end the practice of using life insurance as a blatant tax shelter through the creation of a number of 'definitions of life insurance' and

(2) under Section 7702A, define a permanent way to punish life insurance contract owners who technically comply with the 7702 'definition of life insurance' but still appear to be over-contributing to cash valued life contracts and taking any form of lifetime distribution. This was done through creation of a concept of Modified Endowment contract (MEC).

The above two goals were accompanied by a set of complex actuarial calculations, often performed using first principles, to be invoked throughout the lifetime of any given life insurance contract. Over recent decades, original simplistic support designs have failed to accommodate:

- the many number of types of riders and benefits that can be present on a life contract (and their impacts on these regulatory calculations),
- the many types of changes that can occur through time against an in-force contract (e.g. face increases, face decreases, paid up additions, lapse and reinstate, partial withdrawals, etc.) and
- the impact of true hybrid products now allowed as part of 2006 legislation. (e.g. life base plan with an annuity rider or a long term care rider).

The evolutionary impact of 7702 and 7702A Federal regulations has resulted in local insurer interpretations of what are riders, benefits etc under these laws and when is a change a 'material change'. While these concepts may appear to be straightforward at first consideration (as the concepts appeared to be simple to US Congress back in the 1980s when the legislations were first passed), the reality is the impact is complex. The calculations and fall-out do heavily impact day-to-day life insurance contract administration, especially under 7702A and associated MEC processing. Remedial actions will also vary from insurer to insurer.

The challenge for software designers regarding these regulations is to accomplish supporting each insurer's interpretations within a clearly defined regulatory structure and to be able to distinguish configurable settings grouped into classes of:

- adjustments,
- material changes,
- reductions and
- non-events

based on IRC descriptions and interpretations and industry experiences.

Such configurable settings may be at the corporate level or at the product level. The positions may vary by date ranges or sub-company or both. The distinctions are important to understand when contract 7702 and 7702A values are recalculated and how any recalculations are then performed. Not all real world administrative changes require adjustment nor are all changes "material" from a pure regulatory compliance viewpoint. In contrast, some service actions that do not appear on the surface to be 'change' at all are indeed changes under the regulations.

Insurers today are still stinging from 20-30 years of refining their current support for these pervasive federal regulations and will expect that you as a software provider will have the same respect for the complexity and the pain associated with supporting the law. Companies will want to know what your overall support design is, how flexible is that design to allow local variant interpretations and will not allow you to come in with a 'empty regulatory black box' to fill up as part of the project implementation. They expect your software to reflect some semblance of best practices as part of your base system solution.

Visit: HamiltonSmithassociates.com or contact:
Dan Smith, President
email: Dan.Smith@hamiltonsmithassociates.com