



A M E R I C A N A C A D E M Y *of* A C T U A R I E S

**Report of the American Academy of Actuaries' Annuity Nonforfeiture Section 6 Work Group
On Section 6 of the NAIC Model Standard Nonforfeiture Law for Individual Deferred
Annuities**

**Presented to the National Association of Insurance Commissioners'
Interstate Compact National Standards Working Group**

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Annuity Nonforfeiture Section 6 Work Group

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Report of the American Academy of Actuaries

Executive Summary

In September of 2004, the NAIC Interstate Compact National Standards Working Group requested that the American Academy of Actuaries review the prospective test contained in Section 6 of the NAIC Model Standard Nonforfeiture Law for Individual Deferred Annuities and provide an opinion as to the usefulness and viability of the test in today's deferred annuity marketplace.

The prospective test is a requirement that any cash surrender benefits available prior to maturity not be less than the present value of the paid-up annuity benefit that would be provided under the contract at maturity (the maturity value), where that present value is calculated using an interest rate not more than 1% higher (referred to in this report as the 1% corridor) than the interest rate specified in the contract for accumulating the net considerations to determine the maturity value.¹ If the contract has no fixed maturity date, the maturity date shall be deemed to be the later of the annuitant's 70th birthday or the 10th anniversary of the contract.² The effect of this test is to limit the slope of surrender charges.

In response, the Academy formed this Work Group and focused on the following charges:

1. Provide a historical context for the prospective test including a description of the products that were being sold at the time it was first designed, the status of the financial services industry, and the financial conditions of the time.
2. Identify the original objectives of the test.
3. Contrast the historical context with today's environment. Also, provide a discussion on how the requirements are being implemented in the different states and the types of products that are affected.
4. Discuss and make recommendations regarding the application of the prospective test in today's environment in light of its original objectives.

As a result of this exploration, this Work Group finds that the prospective test is not accomplishing its original objectives in today's environment and should be eliminated from the uniform product standard compliance requirements for all deferred annuity products. However, if it were deemed necessary to continue the prospective test for regulatory reasons, it should only be applied to products with fixed maturity dates, fixed premium schedules and corresponding tabular cash values, as it was originally intended. This narrowing of scope should also be accompanied by an update of the 1% corridor to a wider interest rate corridor more appropriate for today's environment.

The balance of this report will describe the basis for these conclusions. Appendix A quotes the selected sections of the references from the NAIC Model Standard Nonforfeiture Law for Individual Deferred Annuities and from the NAIC Proceedings as referred to in the footnotes.

¹ Reference Section 6 of the NAIC Model Standard Nonforfeiture Law for Individual Deferred Annuities

² Reference Section 8 of the NAIC Model Standard Nonforfeiture Law for Individual Deferred Annuities

Historical Developments

The original Standard Nonforfeiture Law for Life Insurance (SNFL) was developed in the 1940's. Prior to the NAIC annuity nonforfeiture law, the states of New Jersey, New York and Washington had annuity nonforfeiture rules. All sets of rules resembled the SNFL.^{3,5}

In August of 1975, the NAIC appointed a subcommittee to explore development of a model nonforfeiture requirement for annuities.³ The subcommittee was formed to address the emerging individual annuity product market due to rising interest rates and the passage of ERISA.^{3,5} As a result of the work of the NAIC's subcommittee, a nonforfeiture law for annuities was developed, which included the prospective test as an additional limitation on the slope of cash surrender values.

Products Available in the 1970's

During this period of time, most products had the following characteristics:

- Fixed, scheduled premiums
- Tabular cash values
- Paid-up features (if premiums were not paid until maturity), which were often emphasized
- Front-end loading rather than back-end loadings
- A fixed maturity date that generally did not get extended

Development of the Prospective Test

This Work Group has concluded that the development of the prospective test was motivated by one or a combination of the following objectives:^{3,4,6}

- **Insurer Solvency** – To include a 1% corridor as a market value adjustment in recognition of the risk that insurers might have to sell assets at a loss (due to higher interest rates) when policyholders⁷ surrendered their contracts
- **Equity Between Surrendering and Continuing Policyholders** – To provide that if such a market value adjustment was needed, it favored neither persons who surrendered in the years immediately before the maturity date nor those who annuitized on the maturity date
- **Smoothness** – To gradually eliminate any difference between the cash surrender value of the surrendering policyholder and the paid-up annuity value of the continuing policyholder as a policy approached maturity.

The sample calculations in the NAIC Proceedings^{4,6} indicate that the development of the prospective test was viewed significantly differently from how the test is applied today. It appears that in the original development of the rules, the test was based upon the accumulation of the nonforfeiture amount (not the account value) at an appropriate interest rate to a fixed maturity date; that accumulation amount was then discounted back at the same interest rate plus 1%.^{4,6} In addition, the original development of the prospective test did not clarify what the interest rate was meant to represent. It was not the nonforfeiture interest rate because the nonforfeiture interest rate was set at 3% but all examples of the prospective test in the Proceedings used rates greater than 3%.^{4,6} Since the paid-up products of the 1970's did not have any guaranteed accumulation interest rates, the interest rate was most likely the actuarial assumption that the company chose to use in developing the schedule of paid-up values. The test was intended to be applied as a minimum floor as well as a smoothing mechanism, rather than as a cap on (or increase to) surrender charges.⁶ The original test worked well for front-end loaded products with scheduled premiums,

³ Reference NAIC Proceedings 1976, Vol. II, p. 628

⁴ Reference NAIC Proceedings 1976, Vol. II, pp. 630-31, 633

⁵ Reference NAIC Proceedings 1977, Vol. I, p. 492

⁶ Reference NAIC Proceedings 1977, Vol. I, pp. 496-98

⁷ The terms policyholder, policyowner and contractholder are used interchangeably in this report and in the references

but not as well for back-end loaded products with flexible premiums. In recognition of this, the subcommittee introduced Actuarial Guideline III in 1978, which interpreted the application of the test to be based on the cash surrender value of the policy at maturity.⁸

Related Regulatory Developments

When the Variable Annuity Model Regulation and the Modified Guaranteed Annuity Model Regulation were each developed (in 1974 and 1985 respectively), there was no provision for a prospective test. The unit value of a variable annuity and the market value of a modified guaranteed annuity eliminate the need for a separate cushion for recognition of market value risks. The exclusion of the prospective test suggests that there was no other reason to require the test.

In 1991, an Actuarial Advisory Committee was appointed by LHATF to consider revising the Standard Nonforfeiture Law for Individual Deferred Annuities (SNFLIDA).⁹ The Committee issued its draft Report in December of 1992 and was authorized by LHATF to begin drafting a Model SNFLIDA.¹⁰

The Advisory Committee's Report¹¹ indicates that their primary concern with respect to the SNFLIDA was not the "smoothness" of values but rather the maintenance of equity between persisting and terminating (cash surrendering) policyholders¹² and the appropriate protection of companies from the risk of disintermediation. Equity maintenance here was defined in terms of the cost to the company of a policyholder electing the option to surrender the policy versus one not electing that option. In fact, the Committee states that the cost of this option to the insurer "...can be measured as the price of the option granted to the policyowner to receive the lump sum value without adjustment for market value losses of the assets backing such annuity. Such an option mandates that the insurer must invest portions of the funds received in shorter duration securities than it would invest in if such an option were not present. This option has been priced by some studies that indicate this "cost" to be as much as 100 basis points annually."¹³ Cost in this instance was not defined in terms of the recoupment of unamortized acquisition expenses, as surrender charges are commonly thought to reflect, although this is a cost that must be considered.

The Advisory Committee also opined that there were significant concerns with the interpretation of the prospective test as outlined in Actuarial Guideline III and that it should no longer be applicable with respect to new products. Furthermore, they said that the grade-in required by the test was not necessary since it could not prevent the policyholder from continuing beyond an anticipated sharp increase in the policy value.¹⁴

As a result of the research contained in the Advisory Committee's Report, the group's final recommendations did not include a continuation of the prospective test as part of a revised SNFLIDA¹⁵ but rather were focused on maintaining equity between continuing and surrendering policyholders and with protecting companies from the disintermediation risk under different deferred annuity policy structures.

A final revised version of the SNFLIDA was considered in 1995 and was close to adoption by the NAIC, when it was decided to temporarily put it aside until revision of the Standard Nonforfeiture Law for Life Insurance (SNFL) was completed. The purpose was to achieve consistency, and the rationale was that the SNFL was more complex and should lead the way. The revision to the SNFL did not come to completion

⁸ Reference NAIC Proceedings 1978, Vol. II, pp. 412, 414

⁹ Reference NAIC Proceedings 1991, Vol. II, p.1200

¹⁰ Reference NAIC Proceedings 1993, Vol.1B, p.1396

¹¹ Reference NAIC Proceedings 1993, Vol.1B, pp.1427-1433

¹² Reference NAIC Proceedings 1993, Vol. 1B, p. 1430

¹³ Reference NAIC Proceedings 1993, Vol. 1B, p. 1429

¹⁴ Reference NAIC Proceedings 1993, 2Q, p. 1031

¹⁵ Reference NAIC Proceedings 1994, 4th Q, pp. 1099-1108

and the proposal to revise the SNFLIDA was not reactivated. The final draft from 1994 did not include the prospective test.

In 2003 when the NAIC updated the SNFLIDA to include indexing the minimum nonforfeiture value interest rate, the percent of premium loading in the first year on flexible premium products was reduced from 35% to 12.5%, effectively putting narrower limits on the surrender charge. The same revised limits apply to single premium deferred annuities.

Today's Environment

Today, insurance companies compete with banks and other financial intermediaries for savings dollars, but the regulatory landscape is uneven across industries for accumulation products as well as across states for annuities. Interest rates are very different and far more volatile today. Today's products rarely offer the paid-up features that were common in the 1970's. Lastly, both scheduled premium products and fixed maturity dates are considerably less common than they were in the 1970's.

Interest Rates

Interest rates today are very different from the 1970's. The following table provides key interest rate statistics both for the time period 1962-1977 and 1978-2004. The data set is the daily 5-year Constant Maturity Treasury rates (CMT) available from the Federal Reserve Board (series DGS5). That data set begins on 2/1/1962, and the breakpoint at 12/31/1977 was chosen because 1977 was the year in which the original 1% corridor was established (when the annuity nonforfeiture law was adopted):

	1962-1977	1978-2004
Maximum Rate	8.79% ¹⁶	16.27% ¹⁷
Minimum Rate	3.50% ¹⁸	2.08% ¹⁹
Rate on End Date	7.54%	3.30%
Standard Deviation of Daily Rates Over Specified Years	1.43%	2.95%
Standard Deviation of Daily Rates Over Last 5-Years	0.58%	1.25%

Through the time that the prospective test was developed, interest rates had been extremely stable, and the laws were generally written in a manner that reflected the historical stability in the rates. For 2004, however, the interest rate volatilities (standard deviations) are roughly double the comparison results for 1977. While the volatilities are double, the rate itself on 10/31/2004 was only 3.30%, well below the 7.54% rate on 12/31/1977. This lower rate could suggest more interest rate risk for the insurers, as rates have more room to go up.

¹⁶ The 5-year CMT was 8.79% on 8/23/1974

¹⁷ The 5-year CMT was 16.27% on 9/30/1981. For the 16-year period 1/1/1989 through 10/31/2004 (comparable in duration to the 1962-1977 period), the maximum rate was 9.75% on 3/21/1989

¹⁸ The 5-year CMT was 3.50% on 12/24/1962 and 12/26/1962

¹⁹ The 5-year CMT was 2.08% on 6/13/2003

To the extent that the 1% corridor was meant to provide insurers with a cushion against increasing interest rates, an argument can be made that the current interest rate environment would call for a higher corridor.

Products Available in 2005

Today's products are very different from those sold in the 1970's. Consider the following transitions:

- Scheduled premiums have been replaced with flexible premiums, including the ability for the consumer to 'dump-in' large amounts of premiums at any time
- Tabular cash values are mostly absent, today
- Paid-up features (if premiums were not paid until maturity) have lost their emphasis; in its place, it seems the emphasis has shifted to flexible premium accumulations and flexible annuitization
- Front-end loadings have evolved into back-end loadings
- Fixed maturity dates became flexible, to the point where the "later of 10 years and age 70" has virtually no relevance to today's products

Instead of the front-end loaded fixed premium, tabular cash value products of the 1970's, the industry now offers declared-rate annuities, CD annuities, multi-tier annuities, market value adjusted annuities, equity indexed annuities, and bonus annuities.

In the 1970's, the sales pitch was, "Pay \$x per month, and we'll pay you back \$y per month starting at age z and lasting for your life." Today, however, the approach is, "Accumulate money so you can annuitize when you wish." As a result, today's products do not have a primary focus on the annuitization date, although annuitization is clearly an important part of the product offering. Today's focus is more on consumer flexibility through disclosure of contract options and benefits. If a product design includes surrender charges, those surrender charges must be clearly disclosed.

Current Regulatory Environment

As deferred annuity products evolved, regulators sought to interpret the prospective test in ways that would both maintain the goals of the test (as they interpreted them) and allow the viability of these new products as much as possible. At the same time companies were attempting to design products that would fit the different ways the test was applied in different states.

For example, in some states, companies may be required to restrict the policyholder from making additional premium payments on policies with premium based surrender charges because of how those states interpret the prospective test with respect to subsequent premium payments.

Some states also apply the prospective test in a manner such that companies cannot offer surrender charges that grade-off by more than 1%, when the same surrender charge is applied to all issue ages (because the prospective test itself is not consistent in regulating smoothness for all surrender charge patterns and/or ages). The company's pragmatic solution to this problem is sometimes to *raise* surrender charges to achieve a smooth pattern, which is only less favorable to the consumer.

How did this evolution occur? As the accumulation features gained prominence and the paid-up features become less important, regulators sought to apply the prospective test (rooted in products with fixed premiums and tabular cash values) to each new paradigm (moving toward accumulation products with flexible premiums and flexible annuitization). While the decisions along the way may have made sense, the end result became inappropriate for the majority of products being sold today.

It may be worthwhile to note that in the state of New York there is no prospective test, providing a regulatory precedent for removing the prospective test from the annuity nonforfeiture rules. However it should also be noted that another significant difference between New York and the NAIC Model is that New York limits surrender charges to 10% or less. As a result, some products are allowed in New York that are not allowed by the prospective test, and some other products are prohibited in New York that are allowed by the prospective test.

Analysis and Conclusions

This Work Group recommends the elimination of the prospective test. There is no clear actuarial justification for the prospective test as it has been applied to the majority of products sold in today's market place. Following is an analysis of this recommendation in light of the three objectives for instituting the test:

- **Insurer Solvency** – The prospective test does provide some protections to the insurer to address market value losses (due to higher interest rates) for front-end-loaded products. For currently offered annuities with back-end loads the effectiveness is limited, since to the extent the surrender charge is effectively used to cover unamortized acquisition expenses it is not available to address market value risk. Further, the 1% was put into the law in 1977 and to the extent that it reflects interest rate volatility of that timeframe, it is out of step with today's interest rate environment.
- **Equity Between Surrendering and Continuing Policyholders** – Achieving consistency with a formula approach may have been meaningful and effective for contracts with fixed maturity dates; however, it is not possible with the annuity contracts that are currently offered, which have optional maturity dates that are intended to provide more flexibility to the customer. The assignment of a “maturity date” for compliance demonstration purposes does not lead to a meaningful test. In addition, competing products in today's market place rely more on consumer protections in the nature of disclosures rather than formulaic demonstrations of equity, permitting them to offer a broader range of product features.
- **Smoothness** – To the extent that smoothness is imposed by the test, it is very ineffective due to the “maturity date” of the test being different from the actual maturity date, which is unknown in advance for most of today's products. Additionally, the current test is often counterproductive insofar as it encourages the lengthening and increasing of surrender charges to achieve smoothness that will satisfy the test. It also encourages the use of high-age fixed maturity dates to achieve compliance, which reduces consumer benefits.

In summary, the prospective test serves none of its initial objectives. In today's environment, the availability of market value adjustments provides insurers a method to address the market value risk, if they choose. In addition, the reduction of the first-year load in the retrospective test to 12.5% places tighter limits on all surrender charges and provides a constraint on surrender charges that was not addressed by the prospective test. Consequently, there appears to be no reason to continue the test. If it were deemed necessary to continue the prospective test for regulatory reasons, it should only be applied to products with fixed maturity dates, fixed premium schedules and corresponding tabular cash values, as it was originally intended. This narrowing of scope should also be accompanied by an update of the 1% corridor to an interest rate corridor more appropriate for today's environment.

In conclusion, the Work Group recommends that the NAIC Interstate Compact National Standards Working Group eliminate the prospective test from their uniform product standard requirements.

Appendix A

Selected Reference Sections from the NAIC Model Standard Nonforfeiture Law for Individual Deferred Annuities and the NAIC Proceedings

1. Section 6 of the NAIC Model Standard Nonforfeiture Law for Individual Deferred Annuities

For contracts that provide cash surrender benefits, the cash surrender benefits available prior to maturity shall not be less than the present value as of the date of surrender of that portion of the maturity value of the paid-up annuity benefit that would be provided under the contract at maturity arising from considerations paid prior to the time of cash surrender reduced by the amount appropriate to reflect any prior withdrawals from or partial surrenders of the contract, such present value being calculated on the basis of an interest rate not more than one percent (1%) higher than the interest rate specified in the contract for accumulating the net considerations to determine maturity value, decreased by the amount of any indebtedness to the company on the contract, including interest due and accrued, and increased by any existing additional amounts credited by the company to the contract. In no event shall any cash surrender benefit be less than the minimum nonforfeiture amount at that time. The death benefit under such contracts shall be at least equal to the cash surrender benefit.

2. Section 8 of the NAIC Model Standard Nonforfeiture Law for Individual Deferred Annuities

For the purpose of determining the benefits calculated under Sections 6 and 7, in the case of annuity contracts under which an election may be made to have annuity payments commence at optional maturity dates, the maturity date shall be deemed to be the latest date for which election shall be permitted by the contract, but shall not be deemed to be later than the anniversary of the contract next following the annuitant's seventieth birthday or the tenth anniversary of the contract, whichever is later.

3. NAIC Proceedings 1976, Vol. II, p 628

A. Background -- Need for a Standard Nonforfeiture Law for Individual Annuities: The ALIA Subcommittee on Annuity Nonforfeiture Regulation was appointed in August 1975 and charged with reviewing existing and proposed laws and regulations governing annuity nonforfeiture values and with developing a policy on annuity nonforfeiture regulation. For many years, only the states of New York and Washington have had nonforfeiture laws for individual annuities that resembled the Standard Nonforfeiture Law which is applicable to life insurance (several other states have had laws with generally lower requirements). Relatively few individual annuities have been sold by most companies until recently, but two major forces have brought about a substantial increase in the sale of individual annuities during the recent past. First, the higher interest rates that insurers are currently able to credit on individual annuities make them quite attractive as a vehicle for funding individual retirement benefits. Second, the Employee Retirement Income Security Act of 1974 has greatly increased the market for individual retirement benefits provided under HR-10 Pension Plans for the self-employed and their employees, and for Individual Retirement Accounts for those not currently covered by a qualified pension plan. With the increased sales of individual annuities, there have been complaints that nonforfeiture benefits provided under some annuity contracts do not adequately reflect the terminating contractholder's equity in the contract. In response to such complaints, various states have proposed new annuity nonforfeiture legislation or regulation which has been inconsistent with existing regulation in other states or with annuity nonforfeiture benefits that have traditionally been provided by insurers. These developments, the subcommittee felt, indicated the need for a standard nonforfeiture law for individual annuities which could serve as a model for state legislation on this subject.

4. NAIC Proceedings 1976, Vol. II, pp. 630-631, 633

D. Actuarial Equivalence of Cash Values and Paid-Up Annuities

Under the subcommittee's proposal, minimum cash values under contracts which provide both cash and annuity nonforfeiture options would be equal to the Minimum Nonforfeiture Amounts. A question arose on certain types of contracts which guarantee that annuity benefits will be based on Nonforfeiture Amounts greater than Minimum (for example by guaranteeing an accumulation at 5% instead of 3% interest). Requiring full actuarial equivalence of cash values and annuities at all durations would hinder the granting of such higher annuities, because of the problem caused by heavier cash surrenders at times of depressed market values of investments, inherent in providing any intermediate cash surrender benefits. Without a solution to this problem, insurers would tend to use a lower interest rate, or the minimum, in determining the amount of guaranteed paid-up annuity nonforfeiture benefits. The subcommittee therefore sought to develop a method which would permit the cash surrender values at intermediate durations to be less than the actuarially equivalent value of the annuity benefits, but which would at the same time require actuarial equivalence at time of maturity of the contract by a method which would gradually eliminate such differences by that time.

The subcommittee recommends a special provision that in such contracts the cash surrender values be permitted to be equal to the discounted value of the paid-up annuity benefit at maturity computed on the basis of an interest rate not more than 1% higher than the interest rate inherent in computing the paid-up annuity benefits. Thus, the cash surrender value for contracts providing such values would be required to be at least equal to the greater of (1) the Minimum Nonforfeiture Amounts and (2) the present value of the contractually guaranteed paid-up annuity nonforfeiture benefit at maturity of the contract discounted for interest at a rate not more than one percent higher than the interest rate inherent in computing the paid-up annuity benefit. For purposes of the calculations, the paid-up annuity benefit shall be assumed to commence on the latest permitted annuity commencement date specified in the contract but not later than the anniversary of the contract next following the annuitant's seventieth birthday or the tenth anniversary of the contract, whichever is later.

This approach (applicable to contracts offering paid-up annuity nonforfeiture benefits based on Nonforfeiture Amounts greater than the Minimum) enables the insurer to shift its emphasis toward guaranteed paid-up annuity benefits from guaranteed intermediate cash benefits. Such a change in emphasis is proper in an annuity contract. At the same time, a reasonable progression of cash withdrawal benefits grading into the ultimate maturity benefits would be provided for contractholders who wish to cancel their annuity contracts. Appendix II shows some illustrative numerical results (shown on the following page).

APPENDIX II

Proposed Difference Between Annuity and Cash Nonforfeiture Benefits
 For Contracts With Higher Than Minimum Guarantees
 (Based on Annual Payments of \$1,000, Annual Contract Charge of \$35,
 Accumulations 50% (1st Year), 80% (2-10 Years), 85% (Thereafter))

Number of Years From Issue to <u>Maturity</u>	<u>Contract Duration</u>	<u>Annuity Benefit</u>	Assuming that the Accumulation of Nonforfeiture Amounts is <u>Guaranteed at 5% Interest</u>				Percent Difference Between Cash and Annuity <u>Benefit</u>
			<u>Minimum Nonforfeiture Amounts (3% Interest)</u>	<u>Discounted Value of Paid-Up Annuity Benefit</u>	<u>Cash Benefit</u>		
10	1	507	497	465	497	2%	
	5	4,110	3,886	3,919	3,919	5	
	10	9,724	8,727	9,724	9,724	0	
20	1	507	497	423	497	2	
	5	4,110	3,886	3,565	3,886	5	
	10	9,724	8,727	8,845	8,845	9	
	15	17,170	14,602	16,375	16,375	5	
	20	26,672	21,413	26,672	26,672	0	
30	1	507	497	385	497	2	
	5	4,110	3,886	3,243	3,886	5	
	10	9,724	8,727	8,045	8,727	10	
	15	17,170	14,602	14,894	14,894	13	
	20	26,672	21,413	24,260	24,260	9	
	25	38,800	29,309	37,004	37,004	5	
40	30	54,279	38,463	54,279	54,279	0	
	1	507	497	350	497	2	
	5	4,110	3,886	2,949	3,886	5	
	10	9,724	8,727	7,317	8,727	10	
	15	17,170	14,602	13,547	14,602	15	
	20	26,672	21,413	22,066	22,066	17	
	25	38,800	29,309	33,658	33,658	13	
	30	54,279	38,463	49,371	49,371	9	
35	74,035	49,074	70,608	70,608	5		
40	99,248	61,376	99,248	99,248	0		

5. NAIC Proceedings 1977, Vol. I, p 492

An Explanation of the Standard Nonforfeiture Law for Individual Deferred Annuities

1. The Need for A Standard Nonforfeiture Law for Individual Deferred Annuities

For many years, only the states of New York, New Jersey and Washington have had nonforfeiture laws for individual annuities that resembled the Standard Nonforfeiture Law which is applicable to life insurance. Several other states have had laws with generally lower requirements.

Until the last few years relatively few individual deferred annuities have been sold. The rapidly expanding individual annuity market of the last two or three years has been created primarily by two forces:

(a) The higher interest rates that insurers are now able to credit on individual annuities make them attractive for funding individual retirement benefits.

(b) The Employee Retirement Income Security Act of 1974 has greatly increased the market for individual retirement benefits provided under HR-10 Pension Plans for the self-employed and their employees, and for Individual Retirement Accounts for those not currently covered by a qualified pension plan.

The increased sales, coupled with the lack of any statutory control in most states, has stimulated the sale of some contracts providing little or no nonforfeiture benefits in early contract years and inconsistencies in regulatory action to correct that problem. A rising tide of consumer complaints affirms a need for some form of uniform legislation with respect to nonforfeiture values for individual deferred annuities.

6. NAIC Proceedings 1977, Vol. I, pp. 496-498

For contracts providing both cash surrender value and paid-up annuity nonforfeiture options, requiring full actuarial equivalence of cash values and annuities at all durations would hinder the development of deferred annuity contracts providing paid-up annuity nonforfeiture benefits based upon the assumption of interest rates higher than those used in the accumulation of cash surrender values, because of the problem caused by heavy cash surrenders at times of depressed market values of investments which may have to be sold to provide for intermediate cash surrender benefits. The proposed standard legislation permits the cash surrender values at intermediate durations to be less than the actuarially equivalent value of the paid-up annuity value, but does at the same time require actuarial equivalence at the time of maturity of the contract by a method which gradually eliminates such differences as the duration of the contract approaches the maturity date.

The method provided by the proposed standard legislation, with respect to certain types of deferred annuity contracts guaranteeing annuity benefits based upon nonforfeiture amounts greater than minimum, is to require the cash surrender values on such contracts to be at least equal to the greater of either:

(a) The Minimum Nonforfeiture Amounts; or

(b) The present value of the contractually guaranteed paid-up annuity nonforfeiture benefit at maturity of the contract, discounted for interest at a rate not more than one percent higher than the interest rate used in accumulating net considerations to determine annuity benefits.

This approach, applicable to contracts offering paid-up annuity nonforfeiture benefits based on Nonforfeiture Amounts greater than the Minimum, enables the insurer to shift its emphasis toward more generous guaranteed paid-up annuity benefits rather than larger guaranteed intermediate cash values. Such a change in emphasis is proper in an annuity contract. At the same time a reasonable progression of cash

withdrawal benefits grading into the ultimate maturity benefits would be provided for those contractholders who wish to cancel their annuity contracts. Table B3 provides some illustrative numerical results (shown on the following page).

**TABLE B3
INDIVIDUAL DEFERRED ANNUITIES**

**DIFFERENCE BETWEEN ANNUITY AND CASH NONFORFEITURE BENEFITS
FOR CONTRACTS WITH HIGHER THAN MINIMUM GUARANTEES**

BASED ON: ANNUAL PAYMENTS OF \$3000

ANNUAL CONTRACT CHARGE OF \$30

**ACCUMULATING 65% OF THE NET CONSIDERATION FOR THE FIRST CONTRACT YEAR
AND 87.5% OF THE NET CONSIDERATIONS FOR REMAINING CONTRACT YEARS**

**ASSUMING THAT THE ACCUMULATION OF NONFORFEITURE AMOUNTS IS GUARANTEED
AT 4% INTEREST (*)** **ASSUMING THAT THE ACCUMULATION OF
NONFORFEITURE AMOUNTS IS GUARANTEED
AT 6% INTEREST (*)**

n(1)	n(2)	MINIM NONFORE AMOUNTS	ANNUITY BENEFIT	DISCNTD VALUE OF PAID-UP ANNUITY BENEFIT	% DIFF BETWEEN CASH AND ANNUITY BENEFIT	MINIM NONFORE AMOUNTS	ANNUITY BENEFIT	DISCNTD VALUE OF PAID-UP ANNUITY BENEFIT	% DIFF BETWEEN CASH AND ANNUITY BENEFIT		
		NET CONSID ACCUM 3%	NET CONSID AT 4%	CASH BENEFIT AT 5%		NET CONSID ACCUM 3%	NET CONSID AT 6%	CASH BENEFIT AT 7%			
10	1	1988	2008	1842	1988	1%	1988	2046	1881	1988	3%
	5	13436	13826	13180	13436	3%	13436	14634	13963	13963	5%
	10	29787	31459	31459	31459	0%	29787	35112	35112	35112	0%
20	1	1988	2008	1674	1988	1%	1988	2046	1712	1988	3%
	5	13436	13826	11977	13436	3%	13436	14634	12711	13436	9%
	10	29787	31459	28588	29787	6%	29787	35112	31965	31965	10%
	15	48742	52914	50441	50441	5%	48742	62515	59648	59648	5%
	20	70716	79016	79016	79016	0%	70716	99188	99188	99188	0%
30	1	1988	2008	1521	1988	1%	1988	2046	1559	1988	3%
	5	13436	13826	10884	13436	3%	13436	14634	11572	13436	9%
	10	29787	31459	25980	29787	6%	29787	35112	29100	29787	18%
	15	48742	52914	45838	48742	9%	48742	62515	54302	54302	15%
	20	70716	79016	71805	71805	10%	70716	99188	90298	90298	10%
	25	96190	110773	105597	105597	5%	96190	148260	141460	141460	5%
	30	125720	149408	149408	149408	0%	125720	213932	213932	213932	0%
40	1	1988	2008	1382	1988	1%	1988	2046	1419	1988	3%
	5	13436	13826	9891	13436	3%	13436	14634	10535	13436	9%
	10	29787	31459	23609	29787	6%	29787	35112	26492	29787	18%
	15	48742	52914	41655	48742	9%	48742	62515	49436	49436	26%
	20	70716	79016	65252	70716	12%	70716	99188	82205	82205	21%
	25	96190	110773	95961	96190	15%	96190	148260	128781	128781	15%
	30	125720	149408	135773	135773	10%	125720	213932	194758	194758	10%
	35	159952	196415	187237	187237	5%	159952	301814	287971	287971	5%
	40	199637	253604	253604	253604	0%	199637	419421	419421	419421	0%

n(1) INITIAL DEFERRED PERIOD

n(2) CONTRACT DURATION

(*) IN ORDER TO DETERMINE THE VALUE OF THE ANNUITY BENEFIT AT MATURITY

8. NAIC Proceedings 1978, Vol. II, pp. 412, 414

B. Interpretation of Minimum Cash Surrender Benefit Under the Standard Nonforfeiture Law for Individual Deferred Annuities

1. See Attachment B for the text of this guideline [subsequently labeled Actuarial Guideline III]
2. The purpose of this guideline is to provide a recommended uniform interpretation of the provisions of the Standard Nonforfeiture Law for Individual Deferred Annuities with respect to individual deferred annuities with a surrender charge at maturity. At maturity of such contracts, either the annuitant may take the accumulated value without surrender charge and apply such accumulation to purchase an annuity, or the annuitant may surrender the annuity for cash and thereby receive the accumulated value less a surrender charge.

ATTACHMENT B [subsequently labeled Actuarial Guideline III]

INTERPRETATION OF MINIMUM CASH SURRENDER BENEFIT UNDER STANDARD NONFORFEITURE LAW FOR INDIVIDUAL DEFERRED ANNUITIES

Section 6 of the model bill as written does not require that cash surrender benefits be paid; but where they are paid, it requires that such cash surrender benefits grade into maturity value using an interest rate not more than one percent higher than the rate specified in the contract for accumulating net considerations. While this method will be suited for contracts having a sales load at issue, it may create a problem for contracts having surrender charges for cash surrender.

For contracts providing cash surrender values, the cash surrender value at maturity shall be at least equal to the minimum nonforfeiture amount at maturity as defined in section 4. For purposes of calculating cash surrender values prior to maturity, the term "maturity value" in the Standard Nonforfeiture Law for Individual Deferred Annuities shall mean the cash surrender value at maturity.

9. NAIC Proceedings 1991, Vol. II B, pp. 1199 - 1200

An advisory committee was appointed [known as the Actuarial Advisory Committee on Revision of Annuity Nonforfeiture Law]. This advisory committee prepared an interim report and a supplementary report, which the actuarial task force received in December 1990.

The actuarial task force attempted to respond to the advisory committee's request for direction in that supplementary report at its December 1990 meeting. The advisory committee was asked to work on a proposed amendment to the Standard Nonforfeiture Law for Individual Annuities, rather than on revision of an actuarial guideline. At the April 1991 meeting of the actuarial task force, it was agreed to recommend that this project be retitled as project "3h. Nonforfeiture - Study Need for Revision of Annuity Nonforfeiture Law" and to ask that it be reprioritized to a Priority 1 Project. That recommendation was duly adopted.

10. NAIC Proceedings 1993, Vol. IB p. 1396

Attachment One-H is a recent report from the reorganized advisory committee, chaired by Mr. Kayton. This report was discussed in detail at the December 1992 meetings of the Annuity Working Group and the actuarial task force. Mr. Kayton advised that some relatively minor changes in the report are needed, and actuarial task force members had some questions and concerns about parts of that report. Nevertheless, it

was generally agreed by the actuarial task force members that the report offered a good starting point and that work could begin immediately on drafting a proposed model law consistent with the report.

11. NAIC Proceedings 1993, Vol. IB, pp. 1427-1433

The Advisory Committee's Report is included as ATTACHMENT ONE-H, beginning on page 1427-1433 of the referenced Proceedings.

12. NAIC Proceedings 1993, Vol. IB, p. 1430

4) It was recognized that we must maintain reasonable equity between surrendering and persisting contract holders. We also should not establish procedures to limit the rewards to persistent policyowners, provided they meet the other criteria. Instead, the LHATF's objective should be to establish procedures for fairly distributing such benefits among the policyowners.

13. NAIC Proceedings 1993, Vol. IB, p. 1429

The "two-tiered annuity," where one interest rate is available to those policyholders who surrender in a lump sum, whereas a higher rate is available to those who receive their benefit in the form of an annuitization over several years, was developed to reward policyowners who do not subject the insurer to the "cost" of book value surrender. However, critics of this form of annuity argue that those who surrender in a lump sum are receiving an amount that is unfairly low, and that the buyer of such policies might be forced into receiving this lower value by an unexpected emergency.

While this criticism appears to have merit, it ignores the difference in costs to the insurer, which can be measured as the price of the option granted to the policyowner to receive the lump sum value without adjustment for market value losses of the assets backing such annuity. Such an option mandates that the insurer must invest portions of the funds received in shorter duration securities than it would invest in if such an option were not present. This option has been priced by some studies that indicate this "cost" to be as much as 100 basis points annually.

14. NAIC Proceedings 1993, 2nd Q, p.1031

1) Guideline III has been useful to date, but the Resource Group understands that some regulators now believe that it is being misinterpreted, misapplied, or both. Upon adoption of this proposed revision of the nonforfeiture law, Guideline III should no longer be applicable with respect to new products.

5) The present nonforfeiture law provides a definition of minimum cash values at issue that requires a smooth progression of values via the 1% increment used for the discounting of maturity cash values. However, the Resource Group has reason to believe that most companies do not re-apply such grade-in tests after the contract has been issued hence, in practice, there have not been any grade-in requirements. Furthermore, the Resource Group does not believe that it is necessary to require such grade-in requirements, since companies cannot prevent the policyholder from continuing the policy in force beyond an anticipated sharp increase in policy values.

15. NAIC Proceedings 1994 4th Q, pp.1099-1108

The Advisory Committee's final recommendations are embodied in ATTACHMENT ONE-A, the proposed revised STANDARD NONFORFEITURE LAW FOR DEFERRED ANNUITIES (Draft: 12/2/94) as adopted by LHATF, beginning on p 1099 of the referenced Proceedings.