AMERICAN ACADEMY of ACTUARIES

MEMORANDUM

To: NAIC Life and Health Actuarial Task Force

From: Academy Annuity Nonforfeiture Implementation Work Group

Subject: Discussion Document – Scope of Implementation & EIA Grids

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Introduction and Scope

The Annuity Nonforfeiture Implementation Work Group was formed to respond to requests with regard to the implementation details associated with the new model Standard Nonforfeiture Law for Individual Deferred Annuities. This group is also associated with the Academy's work groups on the Generalized Nonforfeiture Project, upon which the Academy relies for a longer-term solution to these issues.

The Annuity Nonforfeiture Implementation Work Group takes on the following three-step scope:

1. Support LHATF in identifying issues associated with the new Annuity Nonforfeiture Law. This includes all issues, not just those relating to Equity Indexed Annuities.
2. Determine which issues are actuarial in nature.
3. For those selected actuarial areas, analyze and explore the issues and provide help in delivering appropriate solutions.

Throughout the tenure of this group, the focus will be on maintaining a relatively short time frame of activity. Anything that might last six or more months will be deferred to the appropriate work group designed to accommodate longer-term solutions.

Sample Equity Indexed Costs

The following table provides cost calculations for two different equity indexed products that provide benefits commensurate with equity indexed products that are currently being sold. For each product, the first two columns identify the option costs under a current, realistic set of assumptions on both a current and guaranteed basis. The subsequent columns provide "shock" assumptions that are in some cases unrealistic. Assumptions are isolated to provide the reader with a texture as to the impact that individual assumptions have on the option costs.

The calculations use one acceptable methodology, but other methodologies may produce slightly different results. Since these are option costs and not market values (as referenced in the Law), some subsequent adjustment may be needed to bring them onto an equivalent basis. Along with these comments, the results are deemed to be reliable for the purposes of this exploration.

Annual Ratchet with Monthly Averaging, Cap, and 100% Participation					
	Best Estimate		Sensitivities		
	Current Basis	Guar'd Basis			
Risk Free Rate	2.0%	2.0%	**1.0%**	2.0%	2.0%
Dividend Yield	1.5%	1.5%	1.5%	**3.0%**	1.5%
Volatility	22.0%	22.0%	22.0%	22.0%	**10.0%**
Cap	10.0%	4.0%	10.0%	10.0%	10.0%
Annual Interest Cost	3.9%	1.9%	3.8%	3.6%	2.5%
Seven Year Point-to-Point with Cap and with 100% Participation					
	Best Estimate		Sensitivities		
	Current Basis	Guar'd Basis			
Risk Free Rate	2.0%	2.0%	**1.0%**	2.0%	2.0%
Dividend Yield	1.5%	1.5%	1.5%	**3.0%**	1.5%
Volatility	22.0%	22.0%	22.0%	22.0%	**10.0%**
Cap	None	50.0%	None	None	None
Annual Interest Cost	3.3%	2.8%	2.9%	2.5%	1.7%

As the above results indicate, today's equity indexed products exceed the new Law's 100 bp maximum allowance for the market value of equity indexed products.

Discussion Points

Through our scope, the Academy's Annuity Nonforfeiture Implementation Work Group has identified several areas for discussion, as follows:

1. Equity Indexed Concerns

   Goal: To have a certification process that allows for "true EIAs" to receive the additional offset from the index rate. It is desirable that this process be simple for the company to produce, simple for the regulator to understand, and provide appropriate assurances that the value of the equity guarantee does exceed the additional offset.

   Questions/Issues

   - What would be needed for a one-time certification at time of policy filing? Would certifications be needed at a later date?
   - Any additional issues if a company uses the redetermination feature for the minimum nonforfeiture rate?
   - How extensive should the certification be? Determine compliance but make no submission, send in only the certification, or send in a demonstration?
   - If a submission is required, can a company certify that under specified ranges of interest rates, dividend yields, and market volatility that specified benefit levels (e.g., participation rate, cap, spread fee, etc.) will always comply? This certification could be stated as items within the company control (caps, etc.) and those due to the market (volatility, risk free rate).
   - If refiling a certification is required for a later period, what time lag is acceptable?
   - How to define a required methodology or accommodate actuarially acceptable differences in calculation method and implicit assumptions?
   - For point to point designs, consideration may need to be given to persistency and how to "average"/discount offset over x year point to point period.

2. Five year CMT

   - Pick a point in time vs. pick a method for products which choose to lock in a nonforfeiture rate at issue with no later reset

   The new law allows the index interest rate to be from any time period as long as the entire time period is within 15 months of the issue date of the contract. Among many choices, this allows a company to choose the day on which the lowest rate occurred during the last 15 months as the index rate. Should some type of averaging, consistency within a policy form, or other constraint be required to limit flexibility in setting the rate? Balancing this ability to choose the lowest rate are the operational limitations of a company. Changing the guaranteed interest rate frequently, possibly on a daily basis, would present administrative issues, policy print issues, field communication issues, and sales material issues.

Clearly, for contracts that will have a redetermination feature, the redetermination nonforfeiture rate will be based on a predefined method of calculating the rate. The question is whether this should also be required for contracts that do not use the redetermination feature.

- Nominal or effective yield

The 5-year CMT rate is the defined index for the nonforfeiture rate. How exactly is this rate chosen? Is it from a defined published source? Is it the nominal or effective yield or is it the daily or monthly rate? What is the objective definition of this rate?

3. CARVM reserves for annuities with redetermination in the nonforfeiture rate

   For a product with a redetermination feature, what rate should underlie the guarantee crediting rates used in CARVM projections?

   - 1%, since this is the minimum possible?
   - 3%, since this is the maximum possible?
   - Same as the nonforfeiture rate immediately before redetermination, since this is a "best estimate"?
   - Same as the nonforfeiture rate for new issues, since this is a "best estimate"?

4. MGA Product loads

   Currently, the MGA model regulation allows a net premium factor of 90% on SPDAs and 65%/87.5% on FPDAs and has annual allowances that differ from those in the revised SNFLIDA. Does the new annuity nonforfeiture law overwrite that language so that the MGA net premium factor is now 87.5% and the annual allowances are consistent? Do regulators want loadings to be consistent on MGA and variable annuity law with the new nonforfeiture law? (The MGA model law has only been adopted in about 5 states.)

5. If the EIA benefit is not available in cash, what impact should that have on the EIA offset allowed?

6. There is value in focusing on a principle-based regulation to accommodate future product designs and to prevent the creation of designs to leverage a "rule" based regulation.

7. There has been at least one request for clarification on re-stating some of the points of the law in "plain English." Some of these points seem clear in the law and some questions have been answered at the LHATF sessions, but if there are questions then it serves the Academy well to try to help provide those answers to its members. The answers provided below reflect the Work Group's understanding of the law and the intent of the law.

- Q: Is it the intention that the guaranteed interest rate not be required to equal the nonforfeiture interest rate?
  - A: Yes. LHATF clarified that the company may set the guaranteed interest rate higher, lower, or the same as the nonforfeiture interest rate, as long as the product continues to comply with the law.
- Q: I have a product with a 3% guaranteed interest rate and no expense loadings. Will I have to refile this product under the new Law?
  - A: Since the product complies under both Laws, it is expected that this product will not need to be re-filed.
- Q: Is it the intention to allow each company to determine with clear disclosure the timing and frequency of the index reset feature?
  - A: Yes. The disclosure has to be specific as well as to the timing and frequency without any discretion on behalf of the company.
- Q: Under 4(B)4, is it allowable to have the initial redetermination period last for the entire life of the contract?
  - A: Yes.
- Q: Is the length of the redetermination period at the company discretion, as long as it is fully disclosed in the contract?
  - A: Yes but the disclosure has to be specific. It is not intended that a company disclose in its contract that it will reset the rate at the company's discretion.
- Q: How does a company go about producing guaranteed illustrations?
  - A: If the guaranteed interest rate is contractually tied to the nonforfeiture interest rate, then use 1%. If the guaranteed interest rate is not tied to the nonforfeiture rate, then it depends on the individual facts and circumstances.
- Q: The averaging period can be no longer than 15 months prior to the issue date/redetermination date. Is that the beginning or end of the averaging period that has to be within 15 months?
  - A: Beginning.
- Q: Can the Treasury rate be rounded to the next highest quarter percent?
  - A: Yes. The law defines the minimum nonforfeiture interest rates. Higher rates would therefore be compliant.
- Q: What implications does the law have on the payout phase of a deferred annuity?
  - A: None.
- Q: What implications does the law have on SPIA's?
  - A: None.
- Q: Is the section on deferral of payments intended to make the deferral optional? It was not optional in the past.
  - A: Yes, it is now optional under the new Model Law.