AMERICAN ACADEMY of ACTUARIES

Nonforfeiture Modernization Work Group
(Formerly the Nonforfeiture Improvement Work Group)

Report to LATF on Guaranteed Nonforfeiture Basis Factor Assumptions

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Scope of Report

Following the presentation of the American Academy of Actuaries' Nonforfeiture Improvement Work Group's (now renamed the Nonforfeiture Modernization Work Group, or NFMWG) August 2011 report, the NAIC's Life Actuarial Task Force (LATF) requested the NFMWG provide additional comments regarding the selection of any regulatory and actuarial "guardrails" applicable to the Nonforfeiture Basis (since renamed the Guaranteed Nonforfeiture Basis (GNFB)) factors, articulated in the contract and used in the determination of the Required Policy Nonforfeiture Account (RPNA) for the policy.

The process of implementing the NFMWG's proposed approach to nonforfeiture reform necessarily involves a rigorous analysis of all of the elements of the proposed approach, including the determination of GNFB factors. Consequently, the content of and initial recommendations made in this Report should be viewed as items for discussion and elaboration rather than final positions on the subject of GNFB factors.

Background

Section IV of the August 2011 Report provides the basic framework the NFMWG used in developing its proposal for nonforfeiture reform. The elements of that framework for reform embody not only an actuarial methodology to be utilized in the determination of nonforfeiture values but also anticipate elements of consumer disclosure and regulatory oversight. In this context, the structure of the proposed approach to nonforfeiture reform can be viewed as a "three legged stool," with the three legs being:

1. An actuarial methodology to be used in determining required nonforfeiture values;
2. An enhanced consumer reporting and information access process; and
3. An enhanced regulatory information system and feedback loop to facilitate oversight, preferably through a centralized statistical agency, of GNFB factors in use in the insurance marketplace.

In order for the proposed revised nonforfeiture approach to be implemented successfully, all three elements of the three legged stool must be in place.

Proposed Approach to Nonforfeiture Mandate Reform

Section V of the Report outlines the actuarial methodology (the first leg of the three legged stool) proposed for nonforfeiture mandate reform. The methodology is titled the Gross Premium Nonforfeiture Method (GPNM) and is a retrospective approach predicated on the prefunding by the policyowner of benefits through premiums paid and interest credited in excess of amounts required to pay benefit and expense charges to date. The value of any non-guaranteed elements (NGEs) that are in excess of the policy guarantees contributes to this amount. The resultant Required Policy Nonforfeiture Account (RPNA) is the nonforfeitable value available to continue the policy "in kind."

It is important to note that the Report specifically distinguishes a policy's "in kind" nonforfeiture value from any available cash surrender value. The Report presupposes an actuarial link between nonforfeiture values (the RPNA) and cash surrender values, should the latter be required. The

Report makes no recommendation as to whether or not cash surrender values should be required when an RPNA is present.

The GNFB factors constitute the actuarial risk factors used in determining the RPNA before reflecting the value of any NGEs. If there are no NGEs under the policy, the GNFB factors are the actuarial risk factors used in determining the RPNA.

The proposed GPNM for the determination of required nonforfeiture values is predicated on one of the elements in the Framework for Reform in Section IV of the Report, specifically the following element:

> "Nonforfeiture regulatory requirements should provide specific guidance with respect to required nonforfeiture value methodologies and general guidance with respect to the establishment of nonforfeiture value assumptions."

As this element of the NFMWG's Framework for Reform indicates, the emphasis should be placed on providing guidance to regulators and actuaries on the choice of GNFB factors, rather than specifically prescribing those risk factors. But a less obvious implication of this element of the Framework for Reform is that it implies the necessity for the second and third legs of the three legged stool to ensure appropriate regulatory oversight and enhanced consumer awareness of the factors used in determining nonforfeiture (and cash surrender, when applicable) values.

The GNFB factors should be chosen such that their use in conjunction with a set of specified premiums, if paid, will provide coverage for the GNFB factor guarantee period specified in the policy. Many factors, including today's usual risk factor elements such as age, sex, and smoking status are typically involved in selecting the GNFB factors. However, additional elements may enter into the selection process, such as policy options and premium structure, and thereby affect policyholder behavior and expected risk factor experience. The NFMWG therefore recommends the following guidance apply to the selection of the GNFB factors:

- Each GNFB factor must reasonably reflect how the corresponding risk factor experience is anticipated to emerge over the period it is in effect.

- Each GNFB factor must be guaranteed over the period or periods stated in the policy.

- Each GNFB factor must be clearly articulated in the policy.

- The GNFB factors must be chosen in such a fashion that, during the period the GNFB factors are guaranteed, the RPNA never becomes negative after becoming positive for the first time.

- The GNFB factors must fund the benefits provided given the risks assumed (including any endowment benefits) under the policy assuming:

    - The specified premiums that are contractually required are actually paid, or

    - If premiums of a specified amount are not contractually required to be paid, a schedule of planned premiums that is used in conjunction with the GNFB factors are paid. For example, under a UL policy, the implication is that the GNFB factors and planned premiums will together fund the benefits provided given the risks assumed for a period dependent upon the timing and amount of the schedule of planned premiums.

- A qualified actuary should be required to certify annually, or at the time a product is filed, that all GNFB factors developed for business issued in that calendar year comply with this guidance.
- An Actuarial Standard of Practice should be promulgated to guide the GNFB factor determination process.
- A company officer should certify annually as to the usage by the company of the GNFB factors as developed and certified by the qualified actuary.

The NFMWG appreciates the opportunity to provide LATF with this overview of the elements involved in the selection of the GNFB factors utilized in the determination of the RPNA under the proposed GPNM nonforfeiture approach. The NFMWG encourages feedback on the contents of this report.