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Update on Activities of the American Academy of Actuaries Nonforfeiture Modernization Work Group

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MULTIPLE GUARANTEES ON UL PRODUCTS and OTHER CONSIDERATIONS

Background and Scope of Report

Pursuant to its charge, the NAIC's Life Actuarial Task Force (LATF) has requested the Nonforfeiture Modernization Work Group (WG) keep it regularly apprised of its continuing discussions and recommendations with respect to various items that need to be addressed to implement the WG's proposed approach to nonforfeiture reform. This proposed approach, the Gross Premium Nonforfeiture Method (GPNM), was outlined in the August, 2011 *Report of the Nonforfeiture Improvement Work Group* (Report).[1]

The actuarial framework for nonforfeiture mandate reform proposed by the WG and articulated in this Report envisions a generalized, risk-based approach to the determination of the "in kind" nonforfeiture value and benefit available to the policyholder. The approach is predicated on the portion of the promised benefits that have been funded to the time when premiums and/or charges for the benefit cease. To date, the WG has limited the scope of its discussions to the approach itself and has not attempted to address related public policy issues. The WG recognizes there are additional considerations and also recognizes their importance and the need for their discussion by all stakeholders involved but considers them at this point to be beyond the scope of the charge given it by the NAIC Life Actuarial (A) Task Force (LATF).

For example, one particular public policy issue with respect to the mandating of nonforfeiture benefits is the trade-off between making such nonforfeiture benefits available and increasing the price to the consumer. If the benefits implied by the GPNM framework are not contained in a particular product, then policyholders could pay a lower price than if such benefits were contained in the product. However, in that case policyholders who lapse would in effect be funding the lower prices for those that remain. This trade-off (between lower prices and the provision of the benefit implied by the GPNM framework) bears discussion by all stakeholders.

The remaining portion of this update to LATF discusses the application of the proposed GPNM approach to universal life policies with multiple (e.g., "secondary") guarantees.

The Gross Premium Nonforfeiture Method (GPNM) Framework for Multiple Guarantees

The proposed GPNM approach to nonforfeiture reform reflects the criteria set out in the framework for reform in the Report. Two of the criteria included in that framework for reform are:

- 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.

- Nonforfeiture values should be based on prefunding resulting from premium payments and credited or charged amounts.[2]

[1] http://actuary.org/files/publications/NFIWG_Final_Report_with_cover_8-22-11.pdf.
[2] See Page 17 of August 2011 AAA "Report Of The Nonforfeiture Improvement Work Group" for the source of these two bullet points.

With respect to multiple guarantees within a single policy, it is important to note that, although labeled a "secondary guarantee", the guarantee provided by a policy no-lapse guarantee (NLG) provision may be a "primary guarantee" under the policy so the secondary guarantee label can be an inaccurate description. The discussion in this report references a benefit under a universal life (UL) policy that guarantees the continuation of the death benefit under certain conditions even when the policy account value is insufficient to keep the policy in force (e.g., zero or negative) and labels that benefit a NLG benefit rather than a secondary guarantee benefit. The risks assumed by the company when it offers an NLG benefit under a life insurance policy include, in addition to the risks assumed under the basic coverage, the risk that a death claim will be made under the policy when the NLG is in effect and the policy account value (AV) is insufficient.

Measuring this risk, and therefore its funding, is dependent upon many contingencies: investment returns, policy funding, mortality experience, premium persistency, lapse behavior, etc. Stochastic modeling is the appropriate approach to assigning a value to the risk over a range of risk classifications such as age, gender, and smoking status. To determine the nonforfeiture value of the NLG benefit for a particular NLG design, it is necessary to determine how to measure the portion of the risk funded as of any point in time while the NLG is in effect.

<u>Measuring the Value Under the GPNM Approach of the NLG Risk That Is Funded for Various NLG Designs</u>

Shadow Account NLG Designs

This is probably the most common class of NLG designs. Although there are many variations as to how a shadow account (SA) is designed, in general so long as the SA is positive, the policy remains in force and any death benefit is payable even if the AV is insufficient. The policy is therefore guaranteed to remain in effect if (i) the account value is sufficient, i.e., the policy value assuming the underlying AV guarantees plus any credited NGEs is sufficient, or (ii) the AV is insufficient and the SA is positive.

Under the GPNM approach, provided the account value guarantees and the SA guarantees meet the "...general guidance with respect to the establishment of nonforfeiture value assumptions" criteria and therefore constitute appropriate Guaranteed Nonforfeiture Basis (GNFB) factors, the Required Policy Nonforfeiture Account (RPNA; the nonforfeiture value) could be defined as whichever of the following produces a greater nonforfeiture benefit:

(a) The RPNA, including the value of any credited NGEs, based on the underlying UL policy account value guarantees, or

(b) The RPNA, including the value of any credited NGEs, based on the SA guarantees during the period the NLG is in effect, and the UL policy account value guarantees thereafter. Where there are multiple NLGs, the largest RPNA at each duration should be used.

Some SA guarantees might not conform to the approach, such that the RPNA related to the SA may need to be an additional calculated value (i.e., not equal the SA value).

It is possible for the nonforfeiture options to differ for the AV-based and NLG-based nonforfeiture benefits. Additionally, if the SA is in effect and the policy is discontinued, there may or may not be an in-kind NLG nonforfeiture benefit as a result of the discontinuation, depending on individual circumstances.

It is imperative that the GNFB factors used meet the requirements and guardrails established for these factors so that the nonforfeiture value represents the appropriate value to the consumer under the policy for the premiums paid.

Premium Fund Test NLG Designs

This type of NLG is fairly common. Variations exist but, in general, these designs do not require the company to maintain a separate SA value to determine whether the policy remains in effect. Maintenance of the policy in force is generally based on a comparison of premiums paid to the sum or accumulation of required premium (RP), typically but not necessarily a level premium, which may be accumulated at interest or with no interest.

In a flexible premium product, the customer does not necessarily have to pay the RP. Under current UL designs, all that is required to support the risks assumed by the company, primarily the mortality risk, is for the policy AV to be positive. Depending on the design, payment of the RP could generate significant prefunding of the risks assumed and yet payment of $1 less than the RP would cause the policy to cease without value if the AV becomes insufficient under the policy guarantees.

This type of NLG design, as typically constructed, in effect substitutes for the SA a pattern of RPs that does not measure risk-prefunding (unless it can be shown that those risks have essentially the same slope as the RPs) and therefore is not generally consistent with the GPNM framework.

Under the GPNM, the underlying assumptions inherent in the RPs would need to be translated into a set of GNFB factors such that the RPs under those assumptions satisfy the NLG. Those GNFB factors would then form the basis of a nominal account value and RPNA similar to the SA NLG design. Thus, Premium Fund Test NLG designs would effectively become Shadow Account NLG designs.

<u>Closing Remarks</u>

The Nonforfeiture Modernization WG appreciates the opportunity to provide this update to LATF and anticipates providing continuing additional reports on the considerations involved in applying the proposed GPNM approach to nonforfeiture for additional life insurance and annuity products and benefits.