AMERICAN ACADEMY *of* ACTUARIES

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

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Background and Scope of Report

Pursuant to its charge, the NAIC's Life Actuarial Task Force (LATF) has requested that the Academy's Nonforfeiture Modernization Work Group (WG) prepare a report of the consumer related and other public policy issues associated with life insurance and annuity nonforfeiture reform, in particular with respect to requirements for cash surrender values when nonforfeiture benefits are present.

The WG's view is that nonforfeiture benefits should be required whenever there is prefunding. Regarding cash surrender values, although cash surrender values and nonforfeiture benefits have historically been equated for most insurance products, the WG's view is that the appropriate focus for nonforfeiture requirements is in-kind benefits, and that the question of whether a cash surrender value should be required is a public policy matter. This issue was covered in the WG's August 2011 report.

The following is a list of some potential public policy considerations associated with requiring cash surrender values in life insurance or annuities and with certain other aspects of nonforfeiture reform. Many of the items in the list have a potential impact on the design, availability, and cost of insurance products. It is important that all stakeholders (regulators, industry, consumer representatives, and others) are informed about these and other public policy considerations and participate in the dialogue as nonforfeiture reform progresses.

Issues to be Discussed

These are the issues for discussion presented below:

- Issues Related to Cash Surrender Values
- Limitations of Current Laws
- Treatment of Existing Products
- Consumer Access to Information

Issues Related to Cash Surrender Values

Effect on consumers
Cash surrender values, if required, may make some existing products more expensive. This may be due to the cash surrender values not being actuarially equivalent to nonforfeiture benefits, or due to the anti-selection opportunities from having additional options. Also, the presence of cash surrender values increases costs by creating additional liquidity needs and disintermediation risk, which are reflected in additional reserving and capital requirements.

Cash surrender values provide value to consumers who no longer need their insurance and are not interested in in-kind benefits. For contracts with non-guaranteed elements (NGE), consumer recourse is limited if the amount credited is unsatisfactory due to a change in company practice or market conditions, and there is no cash surrender value. On the other hand, to the extent nonforfeiture benefits and cash surrender values are not actuarially equivalent, required cash surrender values affect policy costs.

Liquidity and other financial risk
The presence of cash surrender values affects financial results by creating additional liquidity needs and disintermediation risk, whether or not these risks are reflected in additional reserving and capital requirements.

Competitiveness
Cash surrender values, if required, may make certain existing insurance products less attractive.

Tax implications
Federal income tax law requires that life insurance policies with cash surrender values must meet the requirements of Section 7702 (Definition of Life Insurance Rules) and Section 7702A (Modified Endowment Contract (MEC) Rules) to avoid becoming a MEC. If loans and/or liens are provided without cash surrender values or in excess of cash surrender values, they are treated the same as cash surrender values. Before moving forward with reform, potential tax implications of any proposed approach should be examined.

Loan availability
Policy loan availability may depend upon availability of cash surrender values.

Regulations that are responsive to environment change
Invariably, in response to any regulatory change, new products will emerge. Mandatory cash surrender values, if viewed as undesirable by markets and consumers, may prompt development of new products geared toward minimizing them. This could result in a new generation of complex and potentially confusing product designs.

To the extent regulations do not adequately address environmental changes, required cash surrender values could lead to increased disintermediation risk if there is a delayed regulatory response.

Questions as to appropriate determination
If cash surrender values are required to be provided, should there be a mandated actuarial relationship to nonforfeiture benefits? If not, how should considerations of equitable policyholder treatment be addressed?

Unless cash surrender values are required to be equivalent to nonforfeiture benefits, there may be a need for additional actuarial guidance.

Should cash surrender values be allowed to reflect market factors, that is, on an individual basis vs. a class basis?

Do cash surrender values need to be available only at certain times and/or under certain conditions, or must they be available at all times if available at any time?

Consistency
There may be public policy reasons to require cash surrender values for some products and not others. However, because all products may not neatly fit within stated criteria, it may be difficult

to write a set of rules identifying the products that are subject to cash surrender value requirements.

Limitations of Current Laws

Nonforfeiture law has not kept up with product innovation. Many products sold currently do not fit the structure of the existing life or annuity nonforfeiture laws, as the coverages they provide were not contemplated when the laws were devised. This may result in a lack of fair value to consumers commensurate with the risks assumed, and/or a lack of uniformity, where prefunding exists.

- The prescriptive nature of current life nonforfeiture law uses required assumptions vs. risk-based assumptions consistent with the product guarantees, such that nonforfeiture values may not represent the value of prefunding.
- To accommodate product innovation, regulators have made differing interpretations with respect to nonforfeiture requirements, resulting in a lack of uniformity.
- Current nonforfeiture requirements are inconsistent between life insurance and annuities. For example, life insurance requirements are defined in prospective terms whereas annuities are retrospective. Cash surrender value requirements are also inconsistent in that annuity nonforfeiture law allows cash surrender values to be optional. Annuity requirements are based on gross premiums whereas life requirements are based on net premiums that do not necessarily depend on the gross premium.
- In order to provide certain benefits with nonforfeiture values that comply with existing law, the mechanics of certain products may be more complex than would otherwise be necessary, making them harder for consumers to understand (e.g., products with "secondary guarantees"), and/or may be filed as one product and effectively used as another (e.g., level premium term products filed as whole life policies with non-level guaranteed premiums).
- Reform may aid provision of combined coverage for multiple risks, while ensuring consistent consumer value (e.g., "lifecycle" products).

Treatment of Existing Products

Some current products may require changes to comply with any revised nonforfeiture requirements, or they may not be able to comply if they do not fit with the retrospective method. For example, under the Gross Premium Nonforfeiture Method (GPNM) being considered, which is a retrospective approach to determining nonforfeiture benefits, the following issues arise:

- Indeterminate premium whole life products with tabular values may require changes.
- Fixed level premium whole life policies may need to comply by continuing to use the existing nonforfeiture requirements, mostly for administrative reasons.
- Some forms of multiple (no-lapse or secondary) guarantee products use a premium test to determine their status rather than a retrospective accumulation based on assumptions and experience factors and would need to be redesigned to comply with the GPNM approach.
- Some products that do not have required nonforfeiture benefits under current requirements would require they be provided under the GPNM approach (e.g., "level premium term").

Consumer Access to Information

Mandated reform should include enhanced consumer reporting and access to information requirements, whether as part of overall nonforfeiture reform or through other regulations.

Conclusion

The NFMWG appreciates the opportunity to provide this update to LATF and anticipates providing continuing additional reports regarding nonforfeiture reform.

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