AMERICAN ACADEMY of ACTUARIES

Report on Discussion of the Need for General Revision of Standard Nonforfeiture Laws

Presented to the National Association of Insurance Commissioners' Life and Health Actuarial Task Force

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This report was prepared by the Nonforfeiture Improvement Work Group of the Academy's Life Products Committee. The work group is chaired by Noel Abkemeier.

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Report Overview

The Life and Health Actuarial Task Force (LHATF) has entertained the possibility of general revision in the standard nonforfeiture laws during the last two years and the Academy of Actuaries has performed some research and provided reports in support of that type of change; nevertheless, no concerted action has taken place to bring about such a revision. This report has been prepared for the purpose of profiling the benefits of revising the nonforfeiture laws, while recognizing hurdles that must be addressed, and is intended to assist LHATF in determining what direction to take.

This report identifies the constraints imposed upon product design by the current nonforfeiture laws, expanded product designs that could be possible with a new approach to nonforfeiture requirements, and other factors that must be addressed if nonforfeiture laws are to be revised. The report concludes that the potential advantages from making significant revisions in nonforfeiture requirements are considerable, but that there are other significant issues that must be addressed simultaneously in order to achieve an effective transition. The Academy is ready to assist LHATF to the extent desired if the decision is made to broadly revise the structure of nonforfeiture requirements.

Background

The Standard Nonforfeiture Law for Life Insurance was adopted in 1942 and the Standard Nonforfeiture Law for Individual Deferred Annuities was adopted in 1977. Both have been occasionally amended to react to emerging products and their provisions have been extended to new products through model regulations (e.g., variable annuities, variable life, universal life, modified guaranteed annuities, etc.). However, the laws are still are in their original basic form and do not apply consistently across plans and are also not applied consistently across all jurisdictions. Since the introduction of these laws, the business environment for companies subject to the laws has changed dramatically in terms of consumer preferences, the lowering of competitive barriers between insurers and other financial services companies, the introduction and use of new financial instruments, and increased administrative capabilities through technological developments. This suggests the need to revisit the structure of nonforfeiture requirements in a way that will allow insurers to address conditions of the 21st century.

The thrust of the needed changes is a liberalization of product design possibilities that primarily benefits the consumer but also provides reasonable protection of the insurer's ability to operate on a solvent basis. The purpose of nonforfeiture laws is consumer protection, and any revision of the laws must assure that appropriate protections are put in place in recognition of the broadened consumer options. To move beyond the current rule-based laws, it will be necessary to establish a sound set of principles that will serve as the foundation for the revision.

Environmental Change

The business environment has changed for insurance companies, both internally and externally. Customers, competitors, products, and technology have progressed in ways that were unanticipated when nonforfeiture laws were formulated.

- Consumers value flexibility in the products they buy and convenience in dealing with providers of financial services. Customized and personalized solutions for all types of consumer needs are far more common today than before. Customers are also more willing to learn about the products and services they are buying, to make more informed choices.
- Competition from other financial services providers has increased due to deregulation, and the development of similar products that are not subject to these requirements.
- Technology has made it possible to value and administer increasingly complex products. It also facilitates improved communication with customers, a requirement for some of the flexible products described below.

Constraints Under Current Standard Nonforfeiture Laws

The Standard Nonforfeiture Law for Individual Life Insurance and the Standard Nonforfeiture Law for Individual Deferred Annuities (both referenced as SNFL in this paper) were developed when fixed premium policies with book value benefits were the norm and asset-liability management was only indirectly addressed within the insurance industry. The products that characterize the market today have flexible premium requirements and market value or equity value based designs that emphasize consumer choice in funding and/or investment decision making. The current product environment works best with as few inflexible statutory constraints as possible, so that effective asset-liability management can be performed in support of these products that provide for consumer choice and the assumption of risk by the company.

Certain characteristics of the current nonforfeiture requirements represent impediments to development of certain products and also impose some barriers to more effective asset-liability management options. Some impediments are:

- Life insurance nonforfeiture requirements are prospective in nature, whereas many products are flexible premium and hence, in part, retrospective in their operation.
- Premium patterns may dictate cash value requirements despite the fact that this may not be consistent with the consumer's preferences or needs.
- Life nonforfeiture includes a smoothness test of cash values that may not be applicable to current products.

- Life nonforfeiture imputes a nonforfeiture interest rate for the life of the contract, which may not be representative of desirable benefit guarantees nor the investment strategy backing the benefit guarantee. The inconsistency with the investments has the potential of imposing solvency strains in low interest environments.
- Surrender charge limits are based on formulaic expense levels as opposed to actual company costs.
- Both life and annuity nonforfeiture laws limit surrender charge patterns in a fashion that represents a reasonable generalized expense amortization algorithm, but which is somewhat inflexible and may not adequately address specific product and/or company circumstances.
- Nonforfeiture laws do not accommodate other lines of insurance and effectively relegate other line coverages to ancillary benefits rather than comprehensive benefits.
- The life insurance nonforfeiture law does not accommodate market value adjustments that could aid in asset-liability management and add to long-term value for persisters.
- The consumer protection value of existing nonforfeiture requirements are interpreted differently in various jurisdictions, and result in inconsistency and additional unnecessary compliance costs.
- Interpretations vary by state, at least partially as the result of outdated statutory requirements, complicated or misunderstood SNFL objectives, or emerging products not easily integrated into the existing SNFL framework.
- Since the nonforfeiture standards have not changed significantly in many years, it results in some inequity, inconsistency, and confusion when applied to newer, more complex products that were not contemplated in the original law. It is unclear how the law applies to many products that provide valuable consumer benefits.

Potential Benefits of Restructuring Nonforfeiture Laws

The potential benefits of a revision in nonforfeiture requirements can be identified by noting types of products that would bring added consumer benefits, but currently are unavailable due to nonforfeiture constraints (or which can currently be created only through manipulation of the current laws). Changes in the nonforfeiture laws can spur valuable product innovation.

A broad array of possible new products is described below. For most of these product innovations, the value to the consumer is either a more flexible policy that allows multiple needs to be addressed through one purchase decision or the elimination of undesired mandated benefits. This provides the potential for improved efficiency for consumers and insurers, and the increased efficiency may translate into cost savings.

Products with guaranteed cash values below what is currently allowed

No-cash-value permanent life insurance

This product is not allowed under current law. It currently is allowed in Canada. This type of a product is currently being approximated through the use of universal life with secondary guarantees. This can also be approximated through a decreasing term to 100 with a non-guaranteed element equal to the decreased amount.

The consumer value in this product is that it could provide permanent guaranteed insurance at a lower premium. The savings result from the elimination of cash payments upon surrender (although other nonforfeiture benefits could still be provided), improved policy persistency due to the reduced attractiveness of termination, better investment returns due to lengthened liability duration and a resultant ability to invest longer, and the ability of the insurer to reduce costs with less complex administrative systems. Also, the sale is simplified and consumer understanding is increased because of the simplicity of the product.

Straightforward no-cash-value term insurance

Many term insurance policies currently utilize high guaranteed renewal premiums and high maturity ages in order to achieve zero cash values under a unitary cash value calculation. Nevertheless the approach is incapable of achieving zero cash values at high issue ages with the result that term insurance often is not offered above issue age 65. Without formulaic cash value requirements, term insurance without cash values could be offered at all ages. Also, guaranteed renewal premiums could be set at lower, more meaningful levels.

Life insurance policies with non-smooth cash values

This type of product is prohibited by the wording of the "smoothness test" in the current SNFL.

The consumer benefit for this product is that cash values can be generated to fit a plan designed at issue. An example is a product used to help fund college expenses. There could be no cash value for 15-18 years, and then relatively large cash values that are available at that time so a parent can pay college tuition for a child. To the extent that cash values are reduced from what would otherwise be required, there are the same kinds of savings as with no-cash-value life insurance, although the degree of savings is reduced.

Life insurance with nonforfeiture interest rate periodically reset

The recent revision to the Model Standard Nonforfeiture Law for Individual Deferred Annuities introduced indexing of the nonforfeiture interest rate and the capability to reset the rate on the basis of the same index at specified times during the policy lifetime. Low interest environments also affect the ability to support interest guarantees in life insurance products; consequently, there may be value in allowing annuity-type indexing of the nonforfeiture interest rate in life insurance policies. The advantage would be a strengthening of insurers' ability to address or respond to low interest rate environments.

"Cash value plan" life insurance

This product is not allowed under current law, although it was given heavy consideration by LHATF as the basis for a possible revision to the SNFL in 1996-98. The concept is that the cash values are not declared in advance, but rather the method for calculating the cash values is stated in a "plan" that is filed with regulators and committed to by the insurer. Compliance with the plan is then certified annually by the insurer.

The cash values that are produced by the "plan" reflect mortality, interest, lapse, or other specified experience that develops. A variation of the approach might specify a guaranteed minimum interest rate, while experience on the other factors is reflected in the cash values. Another variation might guarantee a cash value floor (perhaps a non-smooth pattern as discussed above) and provide experience-based benefits in addition to that on the basis of a "plan".

The value to the consumer is that a product can be structured with complete flexibility to meet customer preferences at the time of sale. Choice of a "plan" with lower cash value expectations can lead to lower premiums. As the plan reduces guarantees, the insurer can reduce risk-based capital and create savings that can be passed on to the consumer.

Multiple benefit policies

Universal insurance

Universal insurance could be provided in the form of a policy with a single account value from which costs of insurance could be drawn for full levels of coverage to meet the customer's needs in many lines of insurance (e.g., life insurance, annuity funding, medical expense coverage, long-term care, disability income, critical illness, unemployment insurance, automobile insurance, homeowners insurance, etc.). It may be possible to structure the policy on a more traditional chassis while providing the multiple-line benefits. Multiple benefit policies currently are popular in Europe. In the U.S. it is possible to receive approval for life insurance or annuity policies with ancillary benefits from other lines of insurance; however, large amounts of coverage in the secondary lines are not possible because of conflicts in laws and regulations among the various lines of insurance. Additionally, even with the limited coverages, the approach by regulators varies by jurisdiction. An example of currently offered coverage is critical illness coverage on life insurance policies.

Consumer benefits from this type of policy could be numerous. "One stop shopping" is a convenience for the purchaser both at the time of purchase and when subsequently paying premiums or requiring customer service. The combining of significant coverages can reduce issue expense and administrative expense, with a resulting reduction in premium cost. For coverages that require medical underwriting, some portions of the underwriting can be shared efficiently. For lines that normally do not utilize underwriting, it may be possible to use underwriting information from other lines to justify discounts. Some benefits could be mutually exclusive and thereby reduce costs below what might occur with separate purchases. Various benefits may have negatively correlated risk profiles and thus would create a reduced aggregate risk profile that imposes less risk on the insurer and require less capital, again reducing benefit costs.

Multi-generational family policy

This product would make available all the coverages of a universal insurance policy, but also have the ability to transfer from one generation or family member to another. For example, it could be a deferred annuity for a parent, then change to a life policy on a child, and then back to a payout annuity for the parent. Concurrent multi-line benefits could also be offered. The potential consumer and insurer benefits of such a policy are similar to those mentioned for universal insurance. Additionally, there could be the opportunity to reduce aggregate costs and premiums because new sales would be replaced by intensive service, which could allow reduced sales commissions and issue expenses.

Life cycle insurance

This type of policy could provide a sequence of coverages that track the differing needs that emerge at various points in a person's life cycle. The clearest example would be a life insurance policy that changed to a deferred annuity and later changed again to an income annuity with long-term care benefits. Currently this is possible only through the sequential purchase of separate policies because of the incompatibility of life insurance and annuity nonforfeiture requirements.

This type of product would be economically efficient and would provide great convenience to the purchaser. It could "make sense" to consumers and could be popular in the market. It could be even more beneficial if there is the ability to partially convert the cash value into an income stream and continue all or a portion of the life contract simultaneously (i.e., single-benefit changing to multi-benefit).

Market value adjusted life insurance

This product is not allowed under current nonforfeiture law, although some states have made allowances for it. Although there is a model regulation that allows for modified guaranteed life insurance that is similar to the Modified Guaranteed Annuities (MGA) model, this regulation has not been adopted because it was too restrictive and complex. Allowing a company to adjust cash values for market value changes would enable longer duration investments and lower liquidity needs which in turn would improve policyowner value. Other non-cash nonforfeiture options could be available without market value adjustments so that the policyowner does not need to liquidate the policy if premiums are terminated. This provision would also necessitate a change to the policy loan laws and regulations so that the market value adjustment can't be avoided by taking a policy loan.

Other Factors That Must Be Recognized

While there are considerable consumer and insurer benefits that can be realized if products can be designed without the constraints imposed by the current nonforfeiture laws, we recognize that there are other laws, regulations, and practices that may present impediments to developing some of the products described above. A strategy for dealing with these issues will have to be developed so that nonforfeiture revision could be effectively implemented without having counterproductive results. Some of the issues that can create impediments are discussed below.

State regulation intent with multiple line combination products

The current state regulatory framework differs by line of business. Methods must be found to blend, integrate, or isolate the differing requirements.

- Health insurance and property/casualty insurance are regulated in some states via loss ratios while life insurance and annuities each have their own SNFL.

- What is the highest common regulatory denominator for multi line combination products?
- Life insurance and annuities typically have cash values while other coverages may not.
- Statutory reserve methodologies vary among lines of insurance. This would affect both universal insurance and life cycle products.
- Premium taxes vary among lines of insurance. How would universal insurance be handled?
- How would agent licensing be coordinated for multi-line products?
- Disclosure requirements vary by line of business.
- Rate flexibility varies by line of business.
- Risk-Based Capital (RBC) requirements vary among lines of insurance for similar risks. These would need to be integrated.
- Guarantee fund assessments vary by line of insurance.

Consumer protection may be more difficult to achieve

Consumers have been protected by the nonforfeiture laws and by required disclosures. Revision of nonforfeiture laws could reduce or remove some of the customary protective floors and the new product structures could introduce additional complexity that requires more comprehensive disclosure practices. Issues to address include:

- Is increased disclosure at time of sale a sufficient response to reduced guarantees?
- What degree of disclosure is needed to assure that consumers understand the tradeoffs that they may have made?
- How much consumer protection is created by the existence of a competitive marketplace?
- How can purchasers gain a sufficient understanding of blended products and their tradeoffs?
- Can disclosure across multiple lines be effectively achieved?
- To what extent should disclosure be specified by nonforfeiture laws versus independent disclosure requirements?
- Contracts are long-term; how can there be assurance that original “plans” are adhered to in all future years?
- What, if any, requirements should there be for disclosure after time of sale?

IRS guidelines do not address the products being considered

In a manner similar to state regulation, IRS treatment has been product line specific. Company and policyowner taxation issues in relation to combination products and products with reduced or flexible cash values include:

- Within combination products, what determines whether a policy qualifies as life insurance?
- What are appropriate MEC calculations for combination premiums and blended value?
- Policyowner tax treatment of value in a combined policy, e.g., what is the investment in the contract?
- Constructive receipt issues when policy changes into another form.
- Company tax reserve maximum for a contract with no minimum policy value. There is a need to make sure reserve inefficiencies are not created.

- What would be the basis of taxable gain when the economic value of a policy far exceeds the cash value under a flexible structure and a taxable event occurs?

Basic Principles

Assuming there is agreement that the nonforfeiture law should be modified and that the other factors described above can be addressed satisfactorily, the next step is to identify basic principles that can serve as the foundation of a new nonforfeiture law. Fundamental questions dealing with the importance of equity and value for terminators and persisters, the need for nonforfeiture values as a method for guaranteeing value, and the importance of aligning insured and company interests for persistency will need to be answered. With principles in place, then work can begin on developing proposed changes.

Summary

The discussion above suggests the considerable benefits that can be realized by revising nonforfeiture requirements to allow consumer oriented policy designs that are not possible under current nonforfeiture laws. This can be reasonably accomplished only if the changes are based upon sound principles that recognize both the consumer's and the insurer's interest. Additionally, there are significant factors outside the scope of nonforfeiture revision that also must be addressed in order that they not be in conflict with any nonforfeiture revision.

We feel that nonforfeiture revision must be made at some time and the sooner it is addressed, the better. An optimal approach may be to first devise a strategy whereby a path is identified for achieving the necessary changes in other regulatory requirements (e.g., valuation, RBC, disclosure, premium tax, Federal Income Tax, guarantee fund assessments, etc.), so they could complement any changes in nonforfeiture requirements. Then the principles underlying a new nonforfeiture structure could be established. Finally, the actual revised structure could be developed, while at the same time other regulations (e.g., state and IRS) were being modified.