AMERICAN ACADEMY *of* ACTUARIES

Nonforfeiture Modernization Work Group

Treatment of GLWBs in Fixed (including Indexed) Deferred Annuities[1] Under the Proposed GPNM Nonforfeiture Approach

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[1] The term "deferred annuity" in this document refers to that portion of a deferred annuity policy, including an indexed deferred annuity policy, the liabilities for which are backed by the general account assets of an insurer.

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Background and 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 NFMWG Report), the NAIC's Life Actuarial Task Force (LATF) requested the NFMWG keep it apprised of its future discussions and recommendations on various items that need to be addressed to implement the proposed approach to nonforfeiture reform.

In addition, the Kansas Insurance Department (KID) is coordinating a field test on a proposal to simplify the currently proposed approach to principle- based reserves, with the intention to make the audit process more manageable and to evaluate the proper level of statutory reserves for deferred annuities with guaranteed lifetime withdrawal benefits or GLWBs. The KID effort is currently focused on deferred annuities but, if successful, could be applied to other lines of business, such as variable annuities and life insurance. As part of this project, the NFMWG has been requested by the KID to provide commentary regarding the nonforfeiture considerations involved for GLWBs included in deferred annuities under the Gross Premium Nonforfeiture Method (GPNM) approach outlined in the NFMWG Report.

The purpose of this update is to update LATF on the NFMWG's ongoing nonforfeiture reform activities and to provide input to the KID on its field test project.

Recommendation of NFMWG

As part of its charge from LATF[2] on nonforfeiture mandate reform, and within the context of the nonforfeiture approach being considered in its Report, the NFMWG recommends that nonforfeiture benefits are appropriate from an actuarial perspective for GLWBs included with deferred annuities. The NFMWG plans to expand on the actuarial approach proposed here for GLWBs included in deferred annuities to other annuity forms and provide specific examples of such nonforfeiture benefits. In addition, in conjunction with exercising its charge from LATF, the NFMWG plans to review other benefits on the market that may raise issues similar to those presented by GLWBs with respect to nonforfeiture (e.g., GMDBs, GMIBs, ULSGs).

Nonforfeiture Benefit Values for GLWB Benefits

The NFMWG first reviewed the benefits provided by GLWBs in light of the objectives of nonforfeiture reform as indicated on pages 17 and 18 of the NFMWG Report. One of the objectives included in the report states that nonforfeiture values "...provide a fair and equitable value to the consumer." The NFMWG recognizes that the policyholder who surrenders his or her deferred annuity that includes a GLWB gives up a potentially significant benefit.

However, in reviewing the framework for reform through which the objectives of reform are to be accomplished (see page 17 of the NFMWG Report), it was recognized that a purely retrospective approach to developing the value of a GLWB nonforfeiture benefit would not work because the benefit provided is not related in any straightforward manner to the development of the account value; however, it is recognized that a relationship between the account value and the benefit does exist.

[2] The request of the Academy NFMWG states: "*Study the feasibility of a new nonforfeiture law for life insurance and annuities to replace the existing nonforfeiture standards. Provide quarterly status reports on this project.*"

Consequently, the NFMWG decided that the optimal approach regarding nonforfeiture requirements for GLWB benefits consistent with GPNM approach was to define the appropriate nonforfeiture benefit, essentially a prospective effort, and Guaranteed Nonforfeiture Basis (GNFB) factors rather than determining a Required Policy Nonforfeiture Account (RPNA) from which a nonforfeiture benefit of various forms might be derived.

This approach is consistent with the concept of a nonforfeiture benefit being a continuation of policy benefits "in kind" as distinct from benefits payable in cash upon policy cessation. The approach proposed for determining the nonforfeiture benefit for a GLWB included in a deferred annuity is subject to the following requirements:

1. The same reduced paid up benefit is provided whether the underlying annuity is surrendered or the charges for the GLWB cease to be paid.

2. The nonforfeiture benefit is a scaled down version of the full GLWB benefit.

3. There would be no cash surrender option available in lieu of the nonforfeiture benefit because that would effectively be providing a market value put option rather than an insurance benefit.

The approach would provide for a reduced paid up deferred life annuity benefit with the payment amount determined in the following manner: At the time the underlying annuity is surrendered or the charges for the GLWB cease to be paid, a projection of hypothetical future annuity account values, benefits and charges would be performed as if the deferred annuity and GLWB continued without change. The projection would assume commencement of the GLWB scheduled withdrawals at the earliest point in time allowed under the policy. In most cases, the GLWB withdrawals would likely be projected to commence immediately. The nonforfeiture benefit would be a life annuity commencing at the time the account value was projected to be exhausted. The amount of the nonforfeiture benefit payment would be a portion of the scheduled withdrawal amount assumed in the projection. The point in time at which the nonforfeiture benefit would commence would depend on the interest rate(s) used to project the account value forward.

Three alternative calculations were proposed and reviewed for determining the reduced paid up nonforfeiture benefit to be provided. The following three values were used in evaluating these approaches:

- a Present value of future GLWB benefits, assuming the deferred annuity and GLWB continue without change.

- b Present value of future GLWB fees, assuming the deferred annuity and GLWB continue without change.

- c Accumulated value of past GLWB fees.

The three calculations considered for determining the reduced paid up nonforfeiture benefit under a GLWB were:

- (i) Reduced benefit percent determined as 1-b/a

(ii) Reduced benefit percent determined as c/a

(iii)Reduced benefit percent determined as c/(b+c)

Any approach using the value a, the present value of future benefits in combination with either b, the present value of future fees, or c, the accumulated value of past fees, would produce widely varying values depending upon the relationship of the present value of fees to the present value of benefits., As a consequence, the NFMWG decided to recommend approach (iii), in which the reduced paid up benefit is determined by using the ratio of the accumulated value of past fees, c, to the sum of c, the accumulated value of past fees, and b, the present value of future fees. This proposed ratio produces fairly stable results in the value of the reduced paid up benefit relative to approaches (i) and (ii) above.

The NFMWG appreciates the opportunity to provide this update to LATF and anticipates providing continuing additional reports on the applicability of the proposed GPNM approach to nonforfeiture for other life insurance and annuity products and benefits.