



AMERICAN ACADEMY of ACTUARIES

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Report on Nonforfeiture Law Modernization

American Academy of Actuaries' Nonforfeiture Modernization Work Group

Presented to the National Association of Insurance Commissioners'
Life Actuarial Task Force (LATF)

July 2017

Summary

In 2003, the American Academy of Actuaries'¹ (Academy) Life Practice Council formed the Nonforfeiture Improvement Work Group (subsequently renamed the Nonforfeiture Modernization Work Group or NFMWG) to study the possibility of modernization of the Nonforfeiture Law. In 2007, the National Association of Insurance Commissioners' (NAIC) Life and Health Actuarial Task Force (LHATF, subsequently renamed the Life Actuarial Task Force (LATF)) included in its annual list of charges the following: "Study the feasibility of a new nonforfeiture law for life insurance and annuities to replace the existing nonforfeiture standard. Provide quarterly status reports on this project." The work group periodically reported to LATF on its progress.

In August 2011, the work group delivered its most recent [extensive report](#) to LATF, and LATF requested that the Academy continue its work. The work group continued to provide reports to LATF over the next several years as it considered various theoretical and practical aspects of its recommendations. However, in 2016, LATF removed the revision of the nonforfeiture law from its list of charges for 2017. Therefore, the work group ceased further development of its recommendations in late 2016.

This report summarizes the work that has been done by the work group, its recommendations and conclusions, and items that were identified but remain outstanding, so that at such time as LATF wants to move forward, this work will be available.

No action of LATF is being requested at this time other than placing this report in the public record.

Background

Life insurance in the United States has provided nonforfeiture values since the late 1800s. The existing Standard Nonforfeiture Law (SNFL) for life insurance has for the most part remained unchanged since the 1940s, and it is based on providing nonforfeiture values using a prospective present value method

¹ The American Academy of Actuaries is a 19,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

for fixed guaranteed level and single premium products that have gross premiums higher than the net premiums of the product. The SNFL is intended as a consumer protection law that is based on actuarial calculations to provide value for the prefunding in insurance products.

The SNFL does not work well for many modern life insurance products with flexible or non-level premiums or gross premiums lower than the statutory net premium, or for products with economic options that are not valued in the product's statutory net premium. Recognizing that the SNFL does not fit well with many products, some states have applied the law more flexibly than others, leading to inconsistent application of the SNFL.

Nonforfeiture requirements for deferred annuities were introduced in the 1970s, and the current law has retrospective and prospective components. The Standard Nonforfeiture Law for Individual Deferred Annuities (SNFLIDA) has been amended from time to time but also does not fit well with some annuity products covered by its scope—for example, products with market-value adjustments.

Some consumers today have an alternative to nonforfeiture values. There is a secondary market for some life insurance policies and annuities that are no longer needed by their owners. The secondary market can provide a payment to the policyowner when the nonforfeiture value of the policy is less than the current economic value of the policy. For life insurance, the economic value can exceed the nonforfeiture value when the insured has become unhealthy (which tends to increase the economic value of the policy) or when the nonforfeiture value does not fully reflect the prefunding in the policy. However, at present the secondary market is relatively inefficient, generally to the detriment of policyowners, especially for smaller policies. Consequently, the secondary market would seem to be an inadequate replacement for nonforfeiture requirements.

August 2011 Report—Content, Conclusions, Recommendations, Issues for Discussion/Resolution

The August 2011 report discussed the historical context concerning nonforfeiture, outlined potential benefits from and challenges in achieving nonforfeiture reform, and laid out a generalized basis for an update to the nonforfeiture rules called the Gross Premium Nonforfeiture Method (GPNM). It also discussed whether cash surrender benefits need always be available when nonforfeiture benefits are provided and considered some of the public policy issues raised by nonforfeiture.

The report included the following conclusions:

- Existing minimum nonforfeiture value mandates are inadequate to meet the needs of regulators, consumers, and industry in today's dynamic life insurance and annuity market; and
- Consumers would benefit from nonforfeiture mandates that are more transparent and adaptable to the ever-changing product environment.

The report included the following recommendations:

- Current life insurance and annuity minimum nonforfeiture mandates should be replaced with a revised methodology for determining required policy nonforfeiture values;
- Required nonforfeiture values should be determined using a retrospective methodology utilizing actual policy gross premiums and reflecting the prefunded portion of the risks assumed by the company under a policy;
- The required nonforfeiture value methodology should be consistent for life insurance and annuity policies;

- Required nonforfeiture values should include amounts for nonguaranteed elements in excess of the policy guarantees, including, for purposes of this report, dividends that have been declared by the company and included in policy values;
- Enhanced methods of consumer information (relative to that provided today) should be developed for consumers as part of the proposed required nonforfeiture value methodology; and
- Appropriate, timely, and relevant nonforfeiture basis information should be provided to regulators to facilitate oversight of the application of the proposed required nonforfeiture value methodology.

The report included the following items for discussion and/or resolution:

- Whether cash surrender values should be mandated for life insurance and annuity policies when prefunding is present;
- What, if any, guardrails should be placed on the nonforfeiture basis assumptions used in determining required nonforfeiture values; and
- How any tax issues associated with the proposed nonforfeiture methodology should be resolved.

Work Group Activities Subsequent to August 2011

The work group considered a number of issues subsequent to the presentation of the report in 2011, and made frequent reports to LATF. Items considered included:

1. While the Academy can suggest and test updates to the nonforfeiture system, it is up to state regulators to decide whether, and how, the existing nonforfeiture law should be changed.
2. Public policy is an important consideration if changes to nonforfeiture rules are made. Regulators must weigh many factors in reaching a decision, including balancing the interests of persisting policyholders against those of terminating policyholders. The public policy decisions reached by regulators today may differ from those made when the SNFL for life insurance was last changed in the 1940s and the SNFLIDA for annuities was last substantially changed in the 1970s.
3. Many popular modern life insurance products have zero or negligible nonforfeiture values. If nonforfeiture benefits were to be provided for all products with material prefunding, it is likely that the cost of certain current products (examples—level premium term, universal life with secondary guarantees, withdrawal benefits on annuities) would increase, because nonforfeiture benefits that are not currently provided would be available to lapsing policyholders.
4. The application of the GPNM to several products was considered, including whole life, level premium term, universal life (with and without secondary guarantees), annuities (with and without living benefits), and contingent deferred annuities.
5. The nature and development of nonforfeiture factors and the need for guardrails on the underlying assumptions were considered (see the [November 2012 NFMWG report to LATF](#)). The general intent is that nonforfeiture factors must reasonably reflect how the corresponding risk factor experience is anticipated to emerge over the period the nonforfeiture factor is in effect, and that they would be articulated in the policy.

6. The information provided to regulators and consumers related to nonforfeiture values would be enhanced through implementation of GPNM, as envisioned by the work group (see the [April 2013 NFMWG report to LATF](#)). Industry information would be compiled for regulators to use in connection with product approvals. Consumers would receive more transparent information about the value of their policies.
7. If nonforfeiture rules were based on GPNM as envisioned by the work group, certain currently offered products would be affected. For example:
 - a. Level premium term plans would no longer need to use a whole life chassis with a high premium period after the level term period, as the ultimate high premiums would no longer effectively negate the prefunding that typically accumulates during the level term period.
 - b. Universal life products with premium-based secondary guarantees would not generally be able to meet the actuarial requirements for nonforfeiture factors, because continuation of coverage is not linked to prefunding. However, universal life products with shadow accounts would be able to comply if the shadow account assumptions are the same or similar to the assumptions underlying the nonforfeiture factors for the product (see the [August 2014 NFMWG report to LATF](#)).
 - c. Annuity products with additional options such as living benefits or market value adjustments would need to provide additional value in order to comply with these requirements to the extent the options are in the money (see the [December 2013 NFMWG report to LATF](#)).
 - d. Traditional guaranteed fixed level premium life products, with premium differentials among classes but only one set of tabular cash values for all classes, would not meet the GPNM requirements for nonforfeiture factors. However, for such products and where the gross premiums exceed statutory net premiums, it could be argued the current requirements are adequate and that compliance with GPNM would be an unnecessary expense.
 - e. If any of these products are preserved in their current form, a safe harbor may be needed to exempt them from any new nonforfeiture requirements. Public policy would need to be considered if a safe harbor is made available for any product; that is, why one product type is offered a safe harbor when another is not.
8. For the GPNM, the work group focused on the concept of nonforfeiture as a requirement for in-kind benefits, rather than a requirement for cash surrender values. The work group recognized that various additional public policy considerations would affect the determination of cash surrender values, whether required or not (see the [March 2015 NFMWG report to LATF](#)).
9. Other items that would need further consideration include:
 - a. Treatment of nonguaranteed elements once credited to the policy
 - b. Treatment of policy changes