PROJECT HISTORY - 2005

ANNUITY NONFORFEITURE MODEL REGULATION (#806)

1. Project Description

As described in the model, its purpose is to adopt rules to implement the provisions of Section 4 of the Standard Nonforfeiture Law for Individual Deferred Annuities. Revisions to Section 4 of the law were made in March 2003 which: (a) set the minimum nonforfeiture interest rate at a level which varies with the five-year constant maturity treasuries (CMT), subject to a 3% ceiling and a 1% floor; and (b) permits a lower minimum nonforfeiture interest rate for equity-indexed annuities (subject to the 3% ceiling and 1% floor).

2. Group Responsible for Drafting Model and States Participating

The 2005 members of the Life and Health Actuarial Task Force are: New Mexico (Chair), Minnesota (Vice-Chair), Alabama, Alaska, Arkansas, California, Connecticut, Florida, Kansas, Nebraska, New York, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Texas, Utah, and West Virginia.

3. General Description of Drafting Process

The matters described in Project Description were discussed by the Task Force at each quarterly meeting from June 2003 to June 2005. In addition, the Task Force held at least one conference call on this topic during each quarter over that period. Two conference calls were held subsequent to the June 2005 quarterly meeting, including one on September 20, 2005, on which the Task Force adopted the model. All quarterly meetings and conference calls were open to industry personnel. Notice of each conference call was posted on NAIC's Web site and e-mailed to approximately 300 interested parties, including representatives of the American Council of Life Insurers (ACLI).

4. Significant Issues Raised

Numerous contentious issues were debated during the more than two years of effort on this project. The following excerpt from the June 2003 Task Force minutes provides a sense of the wide range of issues addressed:

- Given that the Standard Nonforfeiture Law for Individual Deferred Annuities refers to the "market values" of equity-indexed benefits and not their theoretical costs, some means will need to be agreed upon to convert formulaic or modeling results to market values. Consideration will need to be given as to how to incorporate persistency into the determination of the market value of an equity-indexed benefit.
- How will a company demonstrate the appropriateness of a reduction in the nonforfeiture interest rate when the participation rate in the equity index can vary from one year to the next?
- From the American Academy of Actuaries report relative to equity indexed concerns: "Any additional issues if a company uses the redetermination feature for the minimum nonforfeiture rate?"
- How much variable language should be allowed in policy filings, i.e., to what extent should the specific nonforfeiture rate to be applied to the policy be left blank?
- Does a specific number need to be developed for what constitutes "substantive participation in an equity indexed benefit?"
- Several Task Force members expressed support for the position that the period over which the minimum nonforfeiture interest rate is determined should not be affected by the actual level of the five-year CMT. For example, a company could not use the lowest five-year CMT rate over the prior fifteen-month period. Rather, it would have to specify a specific date or period during the prior fifteen months over which the five-year CMT will be determined, regardless of the actual level of the CMT.
- How much detail should be disclosed to the consumer and included in the contract regarding how the initial and redetermined minimum nonforfeiture interest rates are determined? How much detail should be in the memorandum supporting the policy filing?

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While all of the above and many more issues were addressed during the drafting of the model, the following two questions proved especially difficult to resolve, i.e., the extent to which differing minimum nonforfeiture interest rates should apply to (1) considerations (i.e., premium payments) paid at different times, and (2) the equity and non-equity components of the contract, i.e., one rate per contract.

Question #1: Does the Law bar the use of minimum nonforfeiture interest rates that vary according to the timing of the receipt of considerations (the so-called "premium bucket" approach)?

This question was discussed over a period of a year and one-half, and the Task Force reversed its position on more than one occasion during that period. The Task Force eventually decided to reject the "premium bucket" approach. The following excerpt from the minutes of the Task Force's October 14, 2004, conference call summarizes the extended debate:

> Mr. Dino moved, and Mr. Summers seconded a motion "for premium buckets to be excluded from the Annuity Nonforfeiture Model Regulation." A lengthy discussion ensued, during which the previously stated arguments for and against premium buckets were repeated.
>
> Opposed to premium buckets:
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> - The literal wording of the Standard Nonforfeiture Law for Individual Deferred Annuities does not permit premium buckets in the determination of minimum nonforfeiture values.
> - Premium buckets will add complexity in verifying that minimum nonforfeiture standards are being met.
> - Premium buckets will make it more difficult for consumers to understand what the minimum nonforfeiture values are.
> - To the extent precise rules are not developed regarding how partial withdrawals affect minimum nonforfeiture values, there will be no true "minimum nonforfeiture standard."
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> In favor of premium buckets:
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> The arguments in favor of premium buckets are summarized in the Aug. 17, 2004, letter from William Schreiner (ACLI) (Note: the bullet points shown below are extracted from Mr. Schreiner's memo, and were not explicitly listed in the minutes).
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> - The "premium bucket" approach permits the exact alignment of investment credit promises with available investment opportunities – a plus for both the contract owner and the insurer.
> - It permits the avoidance of situations in which insurer interest guarantees exceed the interest available to be earned in the current marketplace – a solvency concern – due to the existence of guarantees established in a more favorable environment.
> - It permits the avoidance of situations in which insurer interest guarantees are below the interest available to be earned in the current marketplace – a contract owner equity concern – due to the existence of guarantees established in a less favorable environment.
> - The premium bucket approach has long been available in the marketplace. Failure to include it in the model regulation, which is intended to clarify the operation of the new law, would effectively bar its use in low interest rate environments. Logic demands that if the new nonforfeiture law can coexist with premium buckets in high interest rate environments (and it can), the new law should not be used as a tool to eliminate its availability in low interest rate environments.
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> The motion passed: Voting "yes" (7): Alaska, California, Florida, Minnesota, New Mexico, Ohio, and Texas; Voting "no" (5): Arkansas, Kansas, New York, Pennsylvania, and Utah; Abstain (2): Connecticut, South Carolina.

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Question #2: Does the Law bar the use of different minimum nonforfeiture interest rates for the equity and non-equity components of the contract, i.e., should there be one minimum nonforfeiture interest rate per contract?

This issue was one of the last to be resolved, and the Task Force reversed its position on more than one occasion. On its call on July 18, 2005, it agreed to permit more than one rate per contract when the contract incorporates equity-indexed benefits, and that was the position incorporated into the final document. The following excerpt from a prior discussion (the March 2005 Task Force minutes) summarizes the points raised during the ongoing debate:

> Some Task Force members questioned why there should be multiple nonforfeiture interest rates within a single contract. Mr. Dino said his preference "would be that we don't start separating and bifurcating components of a contract. Minimum values should be (for) the contract as a whole, and not looking at different benefit perspectives in the contract." Mr. Serbinowski disagreed "because if you have a contract that has both a fixed account and equity-indexed account, you have to deal with two rates." Mr. Bruning said, "Kansas reads the statute the same way Florida reads the statute; there's one rate per contract, and it either provides substantial equity participation or it doesn't." Mr. Dino moved, and Mr. Stone seconded a motion that Subsection 6B be modified as shown and Subsection 6C be eliminated: proposed Subsection 6B - At any point in time, each contract (or certificate) will have one nonforfeiture rate that is applicable to the entire contract. Mr. Summers stated he is opposed to the motion because difficulties will arise in determining if companies are inappropriately marketing equity-indexed annuities with fixed accounts in order to lower the minimum interest guarantee. Mr. Dino responded "if all he (i.e., the consumer) wanted was the fixed account, that's what he should have bought. And if the agent browbeat him into buying something he shouldn't have, give me the agent's name and phone number. I'll take care of that."

Adoption by the Task Force on its September 20, 2005, Conference Call

The Task Force adopted the model on a vote of five in favor, one opposed, and seven members abstaining. While there are undoubtedly multiple reasons for the unusually large number of abstentions, the primary reason appears to be uncertainty over the language in Subsection 6B. Among the matters addressed in that subsection is the determination of the minimum nonforfeiture benefit in the event of transfers and withdrawals for contracts with equity-indexed benefits. Comments were received from members of the industry that there are other methods of determination that are either simpler or equally as valid as that specified in Subsection 6B. Various options were discussed on the Sept. 20 call for providing more flexibility to companies, but no agreement could be reached regarding different language.

Implications of this Project for Accreditation and Codification

Since this project does not deal with solvency monitoring, there is no impact for accreditation and codification.

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