AMERICAN ACADEMY *of* ACTUARIES

MEMORANDUM

To: NAIC Life and Health Actuarial Task Force

From: Academy Nonforfeiture Improvement Work Group

Subject: Report on General Nonforfeiture Revision

Date: 03/10/05

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The Nonforfeiture Improvement Work Group of the Academy of Actuaries has been evaluating possible revisions to the Standard Nonforfeiture Laws since March 2003. We initially identified the need for revision, particularly as it could make available a broad array of more flexible and consumer-oriented policy designs. This was the content of a report to LHATF on June 19, 2003. After considering market demands, regulatory concerns, and income tax implications, we have drafted a possible structure for a revision of the nonforfeiture laws. In this report we have briefly described the structure, made observations about its operation, evaluated it in relation to the originally stated desired benefits, and indicated the observations of tax specialists. We are seeking your comments on this proposal and your suggestions concerning our future activities.

Overview of Proposed Nonforfeiture Law

We approached the development of a structure by first identifying principles that would provide a foundation and then construct components that would embody the principles.

Principles

1. Insurance continuation value is a recognition of excess funding.
2. The law specifies minimum values.
3. The law should not be product-specific.
4. The approach should not impair the current tax treatment of life insurance for the consumer or the insurer.

Concept

- The policyowner is provided two values – an Insurance Continuation Account (ICA), which indicates the value available to provide nonforfeiture benefits, and a Cash Benefit (CB), which is available upon surrender. The two values are calculated separately. The CB is not a nonforfeiture benefit; however, it is required by law.
- The minimum ICA is based upon the accumulation of gross premiums (GP) and declared interest minus current COIs (Cost of Insurance), premium loads, and expense charges. This is based upon the company's Nonguaranteed Element (NGE) Plan, which includes not only an approach for managing NGEs but also limits on charges and interest credits. For products without NGEs, the company would specify the calculation approach.
- Specific nonforfeiture benefits, e.g., extended term insurance and reduced paid-up insurance, are triggered when an insurer-specified event occurs, e.g., non-payment of premium or inadequacy of a real or shadow account. The trigger is not part of the nonforfeiture law. The ICA then becomes the determinant of the amount of nonforfeiture benefit.
- The minimum CB is based upon the accumulation of (a) the lesser of GP minus load and traditional nonforfeiture adjusted premium (TNAP) at (b) a specified interest rate that is not less than a rate that is specified by law minus (c) the COI specified in the current nonforfeiture law minus (d) the expense allowances in the current nonforfeiture law if the TNAP is the premium used.

Observations

- The ICA could bear similarity to features in current products:
  - On whole life (WL) it could be the traditional cash value.
  - On universal life (UL) and universal life with a secondary guarantee (ULSG) it could be the traditional account value.
- The CB reflects a combination of traditional cash value concepts and the accumulation of actual premiums.
  - It is a specified benefit rather than another form of the nonforfeiture benefit.
  - In general, the minimum CB would be somewhat reflective of actual premiums paid, but it would be partially floored by traditional nonforfeiture calculation factors.
  - The requirement of a cash benefit is intended to meet the perceived requirement for continuation of the current tax status on inside build-up.
- The improvements over current nonforfeiture requirements are:
  - The method can be applied evenly over a broad range of products, thus creating a level playing field.
  - Cash benefits are delinked from nonforfeiture values and, thus, can be more flexible.
  - Cash benefit can be more reflective of lower premiums, which can then cycle back into lower cash benefits.
- Regulators have specified that nonguaranteed elements must be required to be managed reasonably if a nonforfeiture law was to be effective. Nonguaranteed elements would not be regulated within the nonforfeiture law, but they would be subject to separate regulation that would serve valuation, risk-based capital, and disclosure practices as well as nonforfeiture.
- The structure is transferable to other product lines, such as long-term care and disability income.

Advantages under Proposed Nonforfeiture Law

The June, 2003 report indicated that various types of product flexibility to meet consumer needs could be facilitated by changing constraints that exist within current nonforfeiture law structure. The specific product possibilities listed in that report were:

Products with guaranteed cash values below what is currently allowed

- no-cash-value permanent life insurance
- straightforward no-cash-value term insurance
- life insurance policies with non-smooth cash values
- life insurance with nonforfeiture interest rates periodically reset
- “Cash value plan” life insurance

Multiple benefit policies

- multi-line universal insurance
- multi-generational family policy
- life cycle insurance

Market value adjusted life insurance

- market value adjusted life insurance

The proposal achieves these expectations in relation to the specified flexibility in the following ways:

Profile of Product Availability under Proposed Nonforfeiture Law Design		
Product Design not Currently Possible	**Available under Proposal?**	**Comments**
No-cash-value permanent life insurance	No	May impair tax status.
Straightforward no-cash-value term insurance	No	The extension of no-cash-value structures beyond the current allowances, e.g., less than 20 years and before age 71, may impair tax status.
Life insurance policies with non-smooth cash values	Yes	Cash values would have to exceed stated minima.
Life insurance with nonforfeiture interest rates periodically reset	Yes	Probably fits within the proposal, but requires modification of current SNFL formulae.
"Cash value plan" life insurance	Not yet addressed	Cash values would have to exceed stated minima. Disclosure issues would need to be addressed.
Multi-line universal insurance	Possibly	The formulae could be universally applied to various lines of insurance. Many issues with regulation and reserving.
Multi-generational family policy	Possibly	Possible tax issues with generational deferrals.
Life cycle insurance	Yes	Reserving issues could be significant.
Market value adjusted life insurance	Not yet addressed	Current Model Law permits in limited contexts, and this could be expanded.

Federal Income Tax Issues

The operation of life insurance is closely intertwined with Federal Income Tax laws and regulations that address the taxation on the policyowner and requirements for the reserve increase to be recognized as a corporate income tax deduction. Life insurance tax specialists have begun to evaluate the federal income tax implications of the proposed structure. This Work Group will work closely with the AAA Tax Work Group to identify and resolve potential tax issues.

Consideration of Project Direction

This proposal is intended to increase the opportunities for flexibility in product design while providing satisfactory regulatory controls. Some constraints on flexibility have already been imposed in the form of precluding no-cash-value designs in order to avoid what was perceived to be a clear risk to maintaining tax-deferred status on inside build-up. The current proposal focuses on level-premium and flexible-premium life insurance and is intended to be a foundation upon which other designs and types of products, e.g., annuities, would be added. We are interested in receiving your reactions and suggestions concerning the future direction of our efforts. Some possible areas for you to address are:

- Is the scope of the changes appropriate?
- Does the concept of approaching nonforfeiture on a purely retrospective basis provide the desired degree of consumer protection?
- Does the structure of allowing the cash benefit to be independent of the nonforfeiture value provide the desired level of consumer protection?
- Does the required reliance upon a Nonguaranteed Element Plan that is external to the nonforfeiture law provide the type of limitation on the management of nonguaranteed elements that regulators desire?
- Are there specific dimensions that should be added to or removed from the concepts in the proposal?