



AMERICAN ACADEMY *of* ACTUARIES

TO: Sheldon Summers; Innovative Products Work Group

From: Donna Claire, Chair - American Academy of Actuaries
Equity Indexed Products Nonforfeiture Work Group

Date: May 28, 1999

Subject: Comments on Proposed Actuarial Guideline NF-ZZZ

Attached is a copy of our report in response to our request for comments on proposed Actuarial Guideline NF-ZZZ.

* The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

NF-ZZZ and the Standard Nonforfeiture Law for Individual Deferred Annuities

Background

The American Academy of Actuaries' Equity Indexed Products (EIP) Work Group was asked to comment on a proposed Actuarial Guideline on the nonforfeiture benefits that should be imposed on an equity indexed annuity product (known as Actuarial Guideline NF-ZZZ).

The Academy's EIP Work Group has had several conference calls. Since an Actuarial Guideline is used to clarify existing laws and regulations, we went back to the NAIC model Standard Nonforfeiture Law for Individual Deferred Annuities to determine what the current law has stated as minimum nonforfeiture amounts. An additional source of guidance was Actuarial Guideline X, "Guideline For Interpretation of NAIC Standard Nonforfeiture Law for Individual Deferred Annuities".

This paper discusses the issues raised by this group.

Other Considerations with regard to nonforfeiture amounts

The contract wording may provide for greater minimums than the standard nonforfeiture law. If so, these higher amounts would then become the minimums for a particular contract. For example, for most equity-indexed annuities, the minimum amount is recalculated at the end of a guarantee period. This amount, as long as it is higher than the minimum according to the nonforfeiture law, would govern for future years.

Some state laws, regulations, or practices may require benefits richer than the NAIC model standard. If so, the state law would govern for all policies issued in that state.

Does the phrase "additional amount credited..." in Section 4 of the NAIC model Standard Nonforfeiture Law for Individual Deferred Annuities apply only to policy indebtedness?

The wording of Section 4: Minimum values of the Standard Nonforfeiture Law for Individual Deferred Annuities states that:

"The minimum values as specified in Sections 5,6,7,8 and 10 of any paid-up annuity, cash surrender or death benefits available under an annuity contract shall be based upon minimum nonforfeiture amounts defined in this section.

- A. With respect to contracts providing for flexible considerations, the minimum nonforfeiture amount at any time at or prior to the commencement of any annuity payments shall be equal to an accumulation up to such time at a rate of interest of three percent (3%) per annum of percentages of the net considerations (as hereinafter defined) paid prior to such time, decreased by the sum of:

- (1) Any prior withdrawals from or partial surrenders of the contract accumulated at a rate of interest of three percent (3%) per annum; and
- (2) The amount of any indebtedness to the company on the contract, including interest due and accrued, and increased by any existing additional amounts credited by the company to the contract.”

Due to the construction of the sentence there was some question as to whether the “additional amounts credited” only referred to additional amounts on the policy indebtedness. The Work Group also examined the California and Texas versions of the nonforfeiture law for individual deferred annuities, which have the same words, but somewhat different punctuation in the equivalent of Section 4(A)(2), which clarifies that the additional amounts do not refer to simply the policy indebtedness. The Work Group therefore recommends that “additional amounts” be interpreted to not refer to amounts credited on policy loans, but instead referred to amounts credited to the policy.

Does the “additional amounts credited” refer to excess interest credited?

There is an issue as to whether the “additional amounts credited” refers to the excess interest credited to a contract. Actuarial Guideline X addresses this question in connection with Section 6 of the NAIC Model Standard Nonforfeiture Law for Deferred Annuities, which addressed the Calculation of Cash Surrender Value. The question was whether excess interest credits are included in the definition of “any additional amounts credited by the company to the contract” and therefore not eligible to have a surrender charge applied against them, or whether it was part of the maturity value and therefore would be allowed to have surrender charges applied against it.

Actuarial Guideline X concludes that excess interest, if it meets certain definitions, shall not be included in the phrase “additional amounts credited by the company to the contract” in Section 6 of the Model Law. These conditions are:

- (1) Excess interest is declared prior to the period for which it is to be effective, and
- (2) Provided such interest accrues over the effective period.

Would excess interest declared on an equity-indexed annuity be eligible for the above definition?

For an equity-indexed annuity, the excess interest formula is declared prior to the period to which it is effective. Although the actual amount of excess interest is not known in advance, the insurance company has committed itself to a value that it would not be able to change prior to the end of the period. It appears to be a reasonable interpretation to state that the equity-indexed annuity does declare interest rates prior to the period for which it is effective.

It is difficult to state that, for all equity indexed annuities, interest accrues over the effective period, since the formula may be stated in terms of a crediting based on the increase in an indexed value, and this value would not be known until the period ends. Actuarial Guideline X does, however, show that the regulators can provide guidance as to the interpretation of the Standard Nonforfeiture Law for deferred annuities. For the same reason as Actuarial Guideline X used the interpretation as to excess interest it did, to provide for surrender charges to cover all or part of any (1) excess first year expenses not yet recovered, and (2) potential investment losses on surrender, the regulators can choose to treat excess interest on equity indexed products as not falling under the phrase “additional amounts credited by the company on the contract.”

Does the definition of “Minimum Values” in Section 4 of the Model Law require that “maturity values” or “additional amounts credited” be accumulated at a minimum interest rate?

A reasonable interpretation of the Model Law seems to say the answer is no. Section 4 of the Model Law, as quoted on page 1 above, states the minimum nonforfeiture law in terms of net considerations increased at 3%, decreased by prior withdrawals and partial surrenders accumulated at 3%, and decreased by the amount of indebtedness accumulated at interest, with no interest specified for additional amounts credited.

There are some that argue that the “maturity value” is the equivalent of the net considerations, and should therefore be accumulated at a minimum rate of 3%.

Some view additional amounts credited as equivalent to dividends that stay on deposit – the rate of dividend accumulations is not stated in the NAIC model law. There may be minimums specified in the contract or by state regulation.

It should be noted that the New York standard nonforfeiture law for annuities does require a minimum interest rate of 3% on the total accumulation amount, which would include excess interest (Statute 4223 (c)(2)).

General comment on minimum nonforfeiture amounts for deferred annuities

A reasonable interpretation of the Model Law appears to be that the minimum nonforfeiture amount for individual deferred annuities is simply the net considerations (e.g., for SPDAs, 90% of the gross consideration less a contract charge of \$75), accumulated at 3%. This appears to mean that, if the rate declared in the first year of a contract were 4%, the rate declared in the second year could be approximately 2% - the only requirement is that the minimum nonforfeiture amount at any time would be the net considerations accumulated at 3%.

Is there a requirement for equity between new and existing policyholders?

In the NAIC model law, there is no specific requirement as to equity between new and existing policyholders. Some companies do, as a company practice, look at equity between the new and existing policyholders. For equity-indexed annuities, most

companies do state that the minimum nonforfeiture amount in the renewal period will be at least as great as for new customers at that point.

Examples of Various Interpretations of the Crediting of Excess Interest

All the examples below assume an equity-indexed SPDA where the contract specifies a minimum interest rate of 3% on 90% of the premium, and does not deduct a contract charge. The design is a point-to-point, where the additional interest rate is credited at the end of the 7th year. It is assumed that \$1000 is paid in consideration, and at the end of the 7th year, the value of the contract is \$1,500. Of this, \$393 is the excess interest ($\$1,500 - \900×1.03^7).

Interpretation A: Treat excess interest on equity indexed annuities as “additional amounts credited to the contract” and interpret the Model Law to not require 3% interest to be added.

If the regulators determine that excess interest on equity indexed annuities were to be treated as “additional amounts credited to the contract”, this would mean that after excess interest is declared, this excess interest would be treated as the equivalent of a dividend left on deposit, and no surrender charges could be applied against it. For example, even for an annual ratchet design, this would mean that the “traditional” method of deducting a surrender charge as a percentage of the entire account balance could not be used.

The minimum cash value would be defined as the net considerations less withdrawals, both accumulated at interest, and loans, plus the sum of any excess interest declared on the product.

For the above example, interpretation seems to imply that the surrender charge could not be assessed against the \$393. In this interpretation, there is also no requirement that future interest be paid on this amount (unless the contract language calls for it). Therefore, in year 8, the minimum nonforfeiture amount would be $(\$900 \times 1.03^8) + \393 ; in year 9, the minimum nonforfeiture amount would be $(\$900 \times 1.03^9) + \393 , etc.

Almost all of the equity-indexed annuities currently on the market do not comply with the above interpretation, and would have to be redesigned and re-filed.

Interpretation B: Treat excess interest on equity indexed annuities as “additional amounts credited to the contract” and interpret the Model Law to require 3% interest to be added.

This interpretation generally produces the highest nonforfeiture values of all the examples. Like the above example, it would require companies to separate the values into those derived from the base policy and those that occur due to excess interest credited. In the above example, the minimum nonforfeiture value in year 8 would be $(\$900 \times 1.03^8) + 393 \times 1.03^1$, in year 9 it would be $(\$900 \times 1.03^9) + 393 \times 1.03^2$, etc.

This interpretation implies that all dividends left on deposit and excess interest credits on all fixed annuities have a guaranteed 3% accumulation rate.

Interpretation C: Treat excess interest on equity indexed annuities as part of the “maturity value of the contract” and interpret the Model Law to not require 3% interest to be added.

Treating the excess interest on equity-indexed annuities as part of the maturity value should be consistent with the treatment of excess interest on otherwise similar fixed deferred annuities.

Using the above example, it results in the minimum nonforfeiture value in year 8 being $\$900 \times 1.03^8$, the minimum value in year 9 being $\$900 \times 1.03^9$, etc. Language in the contract or due to state regulation could specify higher minimums.

Companies are recognizing this as the floor. However as a policy provision, many companies are raising the minimum cash value for each contract term to be no less than what it would be for a new customer. Using the above example, at the end of the 7th year, companies will typically grant the existing policyholder the greater of the original amount accumulated at 3% ($\$900 \times 1.03^7$) and the accumulated amount less the initial premium charge ($\$1,500 \times .9$). In year 8, this amount would be the greater of $\$900 \times 1.03^8$ and $\$1,500 \times .9 \times 1.03^1$.

Interpretation D: Treat excess interest on equity indexed annuities as part of the “maturity value of the contract” and interpret the Model Law to require 3% interest to be added.

With this definition, the minimum nonforfeiture value in future years would be the greater of the minimum nonforfeiture amount based on the premiums at issue and that based on the additional amount credited, with an initial allowance (e.g., 10%) allowed against this additional amount.

Using the above example, year 8 would be $(\$900 \times 1.03^8) + \$393 \times .9 \times 1.03^1$, the minimum in year 9 would be $(\$900 \times 1.03^9) + \$393 \times .9 \times 1.03^2$, etc.

Possible additional requirement on the above values

To ensure that the nonforfeiture values granted to existing policyholders are never less than those credited to new policyholders, the minimum nonforfeiture amount would have to be restated at the beginning of each term to be the greater of: 1) the original net premium is accumulated at 3%; and 2) 90% of the value of the contract at the beginning of the new term. This is because the application of the 10% premium charge in several periods may reduce the values of the contract in the future below current amounts if the equity-index does poorly over a long period of time. As previously noted, however, there is no specified requirement in the law for equity or equality between new and existing policyholders.

Conclusions

If excess interest declared on equity-indexed annuities were treated similar to dividends on deposit, surrender charges would not be allowed on the additional amounts credited.

If the excess interest declared on an equity indexed annuity were treated as part of the maturity value, the minimum nonforfeiture amount in all years appears to be the net considerations accumulated at 3% - i.e., it should be consistent with the treatment of excess interest on otherwise similar fixed annuities.

The desirability of consistency between retrospective and prospective floors would seem to indicate that the interpretation of Actuarial Guideline X should be extended to the retrospective test and, consequently, the characterization of excess interest amounts as “maturity amount”. This would imply that the floor is determined solely by the initial premium.

There does not appear to be any requirement in the NAIC model law to accumulate the excess interest credited at any rate although contract language and certain state laws (e.g., New York) may require this.

In the past, the American Academy of Actuaries Work Group on Equity Indexed Products has recommended that “EIP designs should be as flexible as possible to meet the differing needs of consumers.” Interpretation C provides the most product flexibility.

In addition, the Academy work group strongly supports clear policyholder disclosure in order to assist the consumer in understanding the features of their contract.

The NAIC model Standard Nonforfeiture Law for Deferred Annuities does not seem to provide a clear-cut answer; it is up to the states at this time to interpret what minimum nonforfeiture amounts are required in their state. An actuarial guideline would provide more consistency among the states. Because the American Academy of Actuaries Work Group on Equity Indexed Products did not feel that there was a single answer, it seems that the regulators must decide which category excess interest credited on equity-indexed annuities falls.

The Academy Work Group would be willing to assist in the development of an Actuarial Guideline.

If you have any question or comments on this report, please contact Donna Claire, Chair of the American Academy of Actuaries EIP Nonforfeiture Work Group.