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**Report of the NF-ZZZ Work Group  
To the Innovative Products Working Group  
of the NAIC's Life and Health Actuarial (Technical) Task Force (LHATF)  
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## DISCUSSION DRAFT

### **The SNFL for Individual Deferred Annuities as It Relates to NFZZZ**

The Innovative Products Working Group (IPWG) of the Life and Health Actuarial Task Force (LHATF) of the NAIC requested the American Academy of Actuaries to assist in a review of a suggested standard for minimum nonforfeiture values for equity indexed annuities (EIA), which had been given the working name NFZZZ. In response, the AAA established the NFZZZ Working Group to study the issue. This interim draft of considerations is a result of the discussions of the NFZZZ Working Group and reflects the issues addressed to date. This document is not a definitive statement, is not a recommendation, and does not necessarily reflect a consensus of the working group. Its primary purpose is to advance the understandings of the IPWG while the working group continues its discussions on NFZZZ.

This is an analysis of the application of Section 4 of the NAIC Model Standard Nonforfeiture Law for Individual Deferred Annuities (SNFL) and its application to equity indexed annuities. It addresses the content of Section 4 of the SNFL, its historic application to products as they emerged, the current interpretation of the SNFL reflected in EIA designs, and several alternative minimum nonforfeiture requirements that could be applied to EIAs.

#### **General Interpretations**

Section 4 of the SNFL establishes a minimum requirement for nonforfeiture values (referred to in this analysis as the unitary requirement); however, the construction of the text leaves ambiguity in the meaning. Additionally, the term “existing additional amounts credited” in the SNFL is not defined and leads to further uncertainty. As a result, differing interpretations of the minimum requirement have resulted. The SNFL recognizes various components in its Section 4 requirements, but it does not strictly separate the requirements into parts; however, as an aid to the discussion in this analysis, the NAIC SNFL's requirements are referred to in two portions—a formulaic part and an additional part. The formulaic part addresses considerations paid and the related prescribed expense allowance limits in determining a floor guarantee that is based upon the cumulative value of net considerations and withdrawals at 3% interest. The additional part addresses contract cash flows other than net considerations, such as the crediting of amounts of investment gain. This part may be determined with reference to contractual provisions or features.

There are two views of the application of these requirements. One is that the unitary requirement provides a floor below which independently determined nonforfeiture values may not fall; however, the additional part within the unitary requirement could increase or decrease from one year to the next. The other view is that the unitary requirement contains a base floor to which certain credited amounts are irrevocably added to create a higher floor. In this latter view, the additional part could never decrease.

In the following discussions, references to interpretations A, B, C, and D refer to possible interpretations of the SNFL as described in the June 1999 Report of the AAA Equity Indexed Product Task Force to the IPWG.

Interpretation A includes cash flows other than considerations as “additional amounts credited” and thus

makes them part of the minimum value. This precludes the assessment of loads against these cash flows in the minimum standard. Interpretation B is similar to Interpretation A, except that the additional amounts credited are required to accumulate at 3% interest in the determination of the minimum values.

Interpretation C recognizes cash flows other than considerations as part of the “maturity value” and thus excludes them from the minimum value calculation. Interpretation D also recognizes the cash flows other than considerations as part of the maturity value, but then includes them in the minimum cash value determination requirement for 3% interest accumulation for subsequent terms.

## **Historic Interpretations of Section 4 of the SNFL for Individual Deferred Annuities**

### *Fixed Annuity with Periodically Declared Interest*

The most basic of deferred annuities has interest declared for one or more years at a time for at least annual crediting on the account value, and has surrender charges expressed as a percent of the account value as an element in the determination of contract surrender value. Such contracts may also have "bonus interest rates" which provide for higher interest rates during the initial guarantee period.

The formulaic component of the NAIC model SNFL requires a cumulative floor of net considerations minus withdrawals accumulated at 3%. The additional component as applied to this design consists of all interest credited to the contract in excess of the 3% accumulated net considerations less withdrawals and permits reduction for surrender charges. The contract specific feature recognized in the required minimum value derived from the additional component is the allowance of a reduction for surrender charge, which is necessary in those cases in which the surrender charge is equal to the full allowance percentage in the net considerations. If this recognition was not given, the full surrender charge could not be charged against the account value in some cases. The practice of recognizing surrender charges on the additional component in relation to the Section 4 compliance is not directly addressed in Actuarial Guideline 10 but is strongly supported by it. The fact that there are approved products with minimum values that are dependent upon the application of a surrender charge against the additional component indicates that there are cases in which interpretations A and B would not be consistent with current practice. Although the current practice described is the predominant practice, it is not universally supported.

The universal practice of insurers has been to guarantee that a current declared rate would never fall below a specified level, which has generally ranged from 3% to approximately 5%, with possible variations by contract year. This practice, driven by the desire to be competitive and found to be affordable in the prevailing interest rate environment, has kept the additional component from decreasing; however, establishment of a lower guarantee, e.g., 2.5%, could present the possibility of an additional component that could decrease in some years. Such a situation would be consistent with only interpretation C. The laws in some states require a 3% annual minimum and these regulators feel that a rate below 3% would be noncompliant.

If surrender charges are applied against premiums rather than the account value, then Interpretations A, B, C, and D are satisfied.

### *“CD Annuity” with Recurring Surrender Charges*

These annuities introduced the concept of having a window during which there is no surrender charge, followed by renewed surrender charges. The additional component recognizes that surrender charges can both increase and decrease. These products can be treated the same as the basic case of a fixed annuity with periodically declared interest. That is, the NAIC SNFL contemplates that the unitary contract surrender value (including surrender charge as appropriate) complies with the unitary value of the nonforfeiture minimum, inclusive of formulaic and additional components.

### *Two-Tier Annuities*

These deferred annuities are characterized by differing nonforfeiture values with respect to an annuitization tier and a surrender value tier. The contract nonforfeiture value of the surrender value tier must comply with the unitary value of the NAIC SNFL minimum. With the single exception that the contract nonforfeiture value of the annuitization tier is equal to or larger than that of the surrender value tier, the two-tier annuity is similar to the fixed annuity with declared interest, and all interpretations of the formulaic and additional components are identical to those described above.

### *Market Value Adjusted Annuities with a Floor Guarantee*

This variant of a market value adjusted annuity generally guarantees that the cash surrender value after the application of the market value adjustment will never fall below a contractually-defined floor described as the premium accumulated at 3%, minus the surrender charge-calculated as a percent of the account value.

The issue was whether this guarantee, which is considered sufficient to preclude the contract from being deemed a security, is also sufficient to satisfy Section 4 of the NAIC Model SNFL. Insurers and most jurisdictions treat the product as a fixed annuity that complies with the SNFL, based upon meeting the formulaic component of the NAIC Model SNFL minimum requirement. A few jurisdictions do not recognize a contractually defined “floor” guarantee as compliant with the SNFL.

This interpretation of the NAIC model SNFL unitary nonforfeiture minimum is particularly relevant for the insight it provides for equity indexed annuities. An MVA annuity with such a floor guarantee and an EIA are similar in structure and operation. Both have a floor guarantee based on a formula derived from formulaic component principles and a separate contractually-defined externally-driven excess interest component that can both increase and decrease but cannot fall below zero.

### **EIA Interpretations of Section 4 of the SNFL for Individual Deferred Annuities**

There are several forms of interest crediting in EIAs. The predominant regulatory practice recognizes the need to allow the non-traditional method of crediting interest while still providing a guarantee that meets the requirements of the SNFL. Due to the irregular crediting patterns (potential of large index based credits, with risk of zero credits) that are essential to the value of an EIA, the additional component has taken a form similar to that of a floored MVA. There are other characteristics of the investment crediting practice that further differentiate an EIA. Crediting of investment gains is often less frequent than on annual anniversaries, and as infrequent as seven years in some “point-to-point” designs. In some contracts the technique of “vesting” is used to recognize partial crediting over a period of time.

### *Interest Credited at the End of a Multi-year Term*

This investment-gain crediting approach, exemplified by a multi-year point-to-point design, provides an annual additional component of zero and credits investment-gain at the end of a contractually defined term. With regard to prevalent industry practice, insurers customarily guarantee minimum values for each succeeding term on the basis of the prior end-of-term account value and the percentage used to determine the initial net premium. This simplifies administration and provides for somewhat comparable benefits to renewing contractholders and new purchasers, although there are situations where the underlying guarantees are more favorable to renewing contractholders than new purchases, and vice versa. However, the contractually defined lifetime guaranteed minimum is based upon the initial net considerations accumulated at 3%. This basically relies upon interpretation C, although interim guarantees may exceed that level.

### *Interest-with-Vesting Annually Credited Throughout Term*

This annual vesting of interest approach is used with some high water and annual ratchet designs. This approach provides an additional component that generally is greater than zero but never below zero; however, the additional component could decrease in the event that the vested portion of the indexed benefit grew at a slower rate than the increase in the formulaic (e.g., 3% of net considerations) component. This reflects interpretation C; however, some jurisdictions require an annual benefit growth of at least 3%, which reflects interpretation B.

### *Interest Credited Annually Throughout Term*

This is the more traditional circumstance in which vesting is 100%. Similar comments as cited in the prior section apply.

## **Extensions of Interpretation C to EIAs**

The IPWG has discussed the four interpretations previously outlined by the AAA NFZZZ Working Group and currently there is not one that appears to be overwhelmingly preferred by the regulators. The insurance industry clearly has stated a preference for Interpretation C, which simply requires that the minimum be a percentage of premiums accumulated at 3%. However, some regulators have expressed concern that Interpretation C by itself may not provide enough protection to policyholders. In an attempt to address concerns of both industry and regulators, we have outlined below four alternative sets of additional requirements that could be imposed on the "additional" cash value portion, in addition to the minimum formulaic requirements in Interpretation C. For simplicity, each alternative is based on a single premium EIA design, ignoring withdrawals.

The descriptions utilize the concept of "term." For this discussion it means the period ending with the first availability of cash surrender values equal to a full account value that includes all equity index based interest credits. For many contracts this will be the end of a decreasing surrender charge schedule; however, the surrender charge schedule is restarted at the beginning of the next term for many contracts.

### *Alternative 1.a.*

The minimum nonforfeiture value is equal to the formulaic guarantee provided by Interpretation C, i.e.,

X% of the premium (90% for a single premium, 65%/87.5% for flexible premiums) accumulated at 3%. In addition, disclosure would be provided to the policyholder that any amounts credited that increase the nonforfeiture value of the contract to an amount greater than the guaranteed minimum could be later lost if the index subsequently performed poorly. This disclosure could be made in the policy or in a buyer's guide. If in a buyer's guide, it would also be suggested that the consumer ask the company to explain how subsequent minimum values are determined and whether additional amounts currently credited could be later lost.

This alternative imposes no quantitative requirements on either EIAs or the four types of fixed annuities discussed earlier (traditional fixed, CD, two-tier, and market value adjusted with a floor guarantee). The EIA disclosure would require careful construction insofar as the purchaser does not perceive the product as a guaranteed fund with excess interest but rather as a policy value with a floor of protection at the end of the term. The disclosure requirements on the four traditional fixed product types would not be significant, insofar as credited interest tends to exceed 3%; however, it is possible some aspects of the EIA-oriented disclosure would have to be adapted to the characteristics of these products. The form and extent of the disclosure could be determined by the states.

#### *Alternative 1.b.*

This is an extension of Alternative 1.a. to include disclosure that a loss of additional credits could be minimized if the policyholder did not renew the contract and instead purchased a new one.

This requirement would have considerable significance insofar as it would encourage customer actions that could have negative impacts on the customer, since each replacement decision would need to be made based on the new and old contract guarantees, contractual provisions, and other factors not related to nonforfeiture values. Such customer actions would also have negative financial impact for insurers and, ultimately, for the entire class of annuity purchasers. This is true in relation to both EIAs and the other four types of fixed annuities. Administration of the requirement would be complicated for any EIA that had more than one benefit variable, e.g., a cap and a participation rate. Similarly, for the four other fixed annuity types, there are complexities, beginning with the general inapplicability of the concept of "term." If a term for these types is considered to be the interest guarantee period, then the combination of changing interest rates and changing surrender charges on products with a one-year guarantee makes the evaluation extremely difficult.

#### *Alternative 2*

The minimum nonforfeiture value is equal to the greater of two guaranteed values. The first guarantee is equal to the formulaic guarantee provided by Interpretation C, i.e., X% of the premium accumulated at 3%. The second guarantee is equal to X% of the account value at the end of the prior EIA term, accumulated at 3% to the end of the current term. At the beginning of each new EIA term, this second guarantee is replaced with a new guarantee, based on the account value at the end of the prior term. This alternative guarantees that a continuing policyholder has a guarantee for the current term no less than that for a new purchaser. It should be noted that this secondary guarantee is already provided in many existing EIA products sold today.

A variation of this option would be to require the greater of the two guaranteed values, together with some or all of the disclosure requirements in 1.a. and 1.b. above.

This alternative would extend the quantitative requirements for EIAs; however, the impact would be somewhat limited due to the current practice by most insurers of providing this guarantee in order to simplify administration and minimize differences that need to be recognized in the sales process. The extension to the four other types of products would require that the minimum guarantee be ratcheted for the next interest guarantee period at least to the level applicable to a new purchaser. This may not be a problem as long as the practice of insurers to guarantee at least 3% annually is continued.

### *Alternative 3*

The minimum nonforfeiture value for an EIA policy in its N<sup>th</sup> term is equal to the greatest of a series of N guaranteed values. The first guarantee is equal to the Interpretation C requirement, i.e., X% of the premium accumulated at 3%. The second guarantee, applicable to contracts in their second and later terms, is equal to X% of the account value at the end of the first term accumulated at 3%. An additional guarantee based upon the account value at the end of the preceding term is added at the beginning of each subsequent term. This process continues until the N<sup>th</sup> guarantee, applicable to contracts in their N<sup>th</sup> term, is equal to X% of the account value at the end of the (N-1)<sup>st</sup> term, accumulated at 3%. This alternative would provide the continuing policyholder with a minimum nonforfeiture value at all durations that is at least as great as that provided to any new policyholder who entered at the beginning of any of the terms.

This level of guarantee would exceed that contained in any EIAs in force or currently being offered and would require mass refile of all contracts currently being sold. Its application to the other four types of fixed annuities would raise their minimum nonforfeiture values; however, it would not affect actual values credited so long as insurers continue to guarantee crediting of at least 3% annually. This guarantee is complex and would run the risk of misunderstandings by agents and purchasers.

### **Summary**

Since Section 4 of the nonforfeiture law did not anticipate many types of new, innovative, and complex product designs, it is not surprising that many different interpretations have emerged since 1976, when the SNFL was drafted. As a result, numerous state variations have developed regarding the required nonforfeiture treatment for different types of annuities. Thus, despite many lengthy discussions at both IPWG and Academy NFZZZ Working Group meetings and conference calls, no consensus has been reached, nor is widespread consensus likely to be reached, on these issues. For these reasons, the Academy NFZZZ Working Group is unable to recommend one method as the appropriate interpretation. One possible approach discussed by the NFZZZ Working Group as an alternative to NAIC legislation or regulation would be to provide a LHATF report to each state insurance department outlining the considerations discussed above, while recognizing that each state has the right to apply the nonforfeiture law in a manner consistent with their current practice.

If there are any questions or comments, please call Noel Abkemeier, Chair of the Academy NFZZZ Working Group.

