The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance.

This report was prepared by the Academy's Disclosure Working Group.

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With appreciation to the many interested parties for their participation in this process.
Introduction

At the request of the NAIC LDWG, The American Academy of Actuaries Disclosure Working Group (Academy DWG) has continued research on annuity supportability tests for illustrating non-guaranteed elements based on its December 5, 1997 report to the NAIC.

The Academy DWG has prepared this status report for the interim NAIC LDWG meeting (February 19-20, 1998). It summarizes for consideration annuity supportability method objectives, attributes, and high level descriptive examples of the possible supportability methods.

The purpose of this preliminary report of the Academy DWG is to objectively present and analyze various methods. At present, the methods and examples are for discussion purposes and are not recommendations. In addition, at this time, no one methodology is suggested to be better than another.

The Academy welcomes the opportunity to provide technical support to the NAIC LDWG as it seeks to decide if an annuity supportability method is necessary and, if needed, what form the method could take. Although as a professional organization the Academy can not determine the necessity of such methods, it can provide expertise in exploring various methods.

Objectives

In its December 5, 1997 report to the NAIC LDWG, the Academy DWG identified a preliminary list of supportability objectives, together with a list of risks that should be addressed in the development of supportability requirements. The Academy DWG recognizes that there may be conflicts among these objectives, creating the necessity for compromise solutions in some supportability methods. As experienced with the Life Regulation, the result is that some of these objectives may not be entirely realized. Based on feedback and further Academy DWG discussions, a revised summary of annuity supportability objectives is shown in Appendix A.

Considerations

Variety of Product Designs

The variety of product designs available in the marketplace makes it more challenging to develop a "one size fits all" supportability test methodology. The variety is partially due to the use of different product design features to manage risk factors.

For example, product designs with higher surrender charges or longer surrender periods will have an increased ability to pass supportability tests. Such features help recover issue expenses and avoid market value losses.
Product designs with longer annuity payout periods will also have an increased ability to pass supportability tests. This results from the ability to recover issue expenses over longer time periods, lower capital costs due to lower risk based capital factors for payouts, and a lower risk of market value losses due to the multi-year liquidation of assets during the payout period.

**Persistency**

Many risk factors are related to changes in persistency having secondary financial impacts. These risk factors include issue expense recovery, market value losses, supportability of long term future values and other items.

The Academy DWG has reviewed the Annuity Persistency Study - 1997 Report by LIMRA and the Society of Actuaries. This Study identifies a number of factors that relate to persistency levels. Important factors include the surrender charge level and its duration. Distribution channels also have a noticeable impact.

**Research and Review Needed**

Before any of the supportability methodologies can be seriously considered, additional research must be completed. Any methodology should work for the variety of annuity products currently offered to consumers. It should also allow for future product innovations and future interest rate environments.

Regulators and industry will need time to review the research results and determine the appropriateness of any proposed methodology. Companies need time to apply any proposed methods to their specific products and situations.

**Intent to Pay vs. Ability to Pay**

The Academy DWG also has discussed the limitations of any supportability methodology to address the company's "intent to pay" illustrated benefits.

The "intent to pay" concept has been the subject of "plan approach" nonforfeiture research by the NAIC. By having a company develop a plan for non-guaranteed elements, a foundation could be created for monitoring actual paid values compared to illustrated values.

The Life Insurance Illustration Regulation self-support and lapse-support tests focused on the "ability to pay." The Life Regulation also took a limited step to monitor actual paid values by requiring the actuary to report any decreases in non-guaranteed elements due to factors other than experience changes. It also required such reporting if there are inconsistencies between paid and illustrated values for the same or similar forms.
Approaches identified by the Academy DWG provide only a limited ability to address the "intent to pay" issue. This concept will continue to be discussed by the Academy DWG.

**Attributes of Various Methodologies**

Discussions have resulted in the development of a spectrum of methodologies ranging from broad supportability testing to supportability disclosure. This spectrum, along with the specific attributes of each methodology are summarized in Appendix B "Attributes of Possible Supportability Methods For Annuity Contracts Illustrating Non-guaranteed Elements." The two left most columns, Dynamic Aggregate Testing Methods and Dynamic Product-Level Testing Methods, are examples of "Rigorous Tests" identified in the December 5 report. The two right columns explore the two other methods contained in the December 5 report, the Static Simplified (Bright Line) Testing Methods and Supportability Disclosure Methods.

**High Level Descriptive Examples**

High level descriptive examples are provided in Appendices C through F.

*Rigorous Testing*

Work done on Rigorous Testing has provided a strong theoretical foundation for discussion simplifications. This work draws from experience with cash flow testing to develop examples. The Rigorous Testing reports are in Appendices C & D.

*Simplified Bright Line Testing*

The Simplified Bright Line Test work undertook the more difficult challenge of trying to capture the essence of supportability by only considering key elements and fewer "moving parts". Much basic research remains, as few "off the shelf" examples are available to guide this work. Appendix E contains the Simplified Bright Line Test report.

*Supportability Disclosure*

The Supportability Disclosure work has drawn from the Academy's work in equity indexed products (including the "balancing language" concept). It has also considered the five year interest rate history proposal in the current NAIC LDWG draft. The Supportability Disclosure work is shown in Appendix F.
Closing Comments

Oral Report for March, Comprehensive Written Report for June

The Academy DWG recognizes the competing needs to keep advancing this project as well as to keep the NAIC LDWG informed.

Because written report development uses a substantial amount of our volunteer resources, the Academy DWG plans on providing an oral update at the March NAIC meeting. Resources will focus on the necessary research and development to provide a more comprehensive written report at the June NAIC meeting.

Actuarial Standard of Practice

The Academy DWG understands an Actuarial Standard of Practice may be needed to complement the annuity supportability tests, if the NAIC Life Disclosure Working Group determines such tests are needed. We will continue to keep the Actuarial Standards Board and its Life Operating Committee informed of our progress.

Comments Welcome

The Academy DWG appreciates the opportunity to assist the NAIC LDWG on exploring annuity supportability testing methodologies. Please do not hesitate to contact either of the co-chairs, Steve Preston or Barbara Lautzenheiser, with any questions or comments about the project to date or its future direction.
Appendix A: Proposed Annuity Supportability Objectives

1. Should ensure that information provided by the company creates consumer expectations for nonguaranteed elements that are not unreasonable.

2. Should address the following (via testing, disclosure, or a combination of both):
   - Lapse risks
   - Disintermediation risks
   - Credit risks
   - Hedging risks
   - Expense risks
   - Mortality risks
   - Antiselection risks
   - Capital/risk-based capital requirements

3. Should address the following types of lapse risk:
   - High lapse risks: The risk that high early lapses may result in supportability problems in later years. High lapse risk is typically greater for products paying high early-year benefits (e.g., products with substantial early-year interest rate bonuses). High early lapses may occur due to such items as:
     a) a spike in interest rates or a bonus rate expiring, and
     b) expiring of the surrender charge.
   - Low lapse risks: The risk that low lapses may result in supportability problems at later durations. Low lapse risk may be greater for products paying higher benefits levels in later years (e.g., products with high long-term annuitization benefits.)

4. Should use, when appropriate, informed actuarial judgement; widespread actuarial practices should not be overturned.

5. Should be consistent with historic regulatory practice of not regulating profit margins.

6. Should be general enough to address both current and future designs, while being specific enough to address the major supportability concerns.

7. Should balance the cost of implementing the requirements with the benefits derived from such requirements.

8. To the extent possible, should support consistency with actuarial concepts and principles underlying proposals by other Academy work groups.
### Appendix B: Attributes of Possible Supportability Methods for Annuity Contracts Illustrating Nonguaranteed Elements

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<tbody>
<tr>
<td><strong>Summary</strong></td>
<td>Rigorous testing similar to valuation actuary testing, to determine ability of company to pay benefits illustrated.</td>
<td>Rigorous testing at a product level, perhaps similar to dynamic product pricing, to determine ability of company to pay benefits illustrated for this product.</td>
<td>Simplified testing at a product level using static assumptions in a prescribed methodology. Designed to be more practical and easier to administer and verify. The Life Insurance Illustration Regulation testing method is in this category.</td>
<td>Focus on attempting to assure that expectations for consumers are not unreasonable using additional supportability disclosure. No specific testing.</td>
</tr>
<tr>
<td><strong>Measurement of ability to pay vs. need for supportability disclosure.</strong> Ability to pay means testing if the company will have the assets to support the benefits.</td>
<td>Higher measurement of ability to pay; lesser need for supportability disclosure.</td>
<td>Fairly high measurement of ability to pay; moderate need for supportability disclosure.</td>
<td>Some measurement of ability to pay; increased need for supportability disclosure.</td>
<td>No measurement of ability to pay; very high degree of supportability disclosure provided.</td>
</tr>
<tr>
<td><strong>What is Tested</strong></td>
<td>Tests the company's ability to pay the benefits illustrated. Doesn't require a test of product supportability.</td>
<td>Tests product supportability. Doesn't test overall company ability to pay.</td>
<td>More standardized test of product supportability. Doesn't test overall company ability to pay.</td>
<td>May explain or illustrate the risks of the product. Doesn't require specific tests.</td>
</tr>
<tr>
<td><strong>Level of Aggregation</strong></td>
<td>Most likely to be performed at a company level, or across broad categories of products. Testing at a company-level is already being done, in most cases, by the valuation actuary.</td>
<td>By product, product line or policy form.</td>
<td>By product, product line or policy form.</td>
<td>By product, product line or policy form.</td>
</tr>
<tr>
<td><strong>Dynamic vs. Static Testing</strong></td>
<td>Dynamic testing under multiple scenarios.</td>
<td>Dynamic testing under multiple scenarios. (possibly fewer scenarios than under dynamic)</td>
<td>Static, single or multiple scenario, test.</td>
<td>Doesn't require specific tests.</td>
</tr>
</tbody>
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## Appendix B: Attributes of Possible Supportability Methods for Annuity Contracts Illustrating Nonguaranteed Elements

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<tbody>
<tr>
<td>Assumptions</td>
<td>Actuarial judgement used to set assumptions.</td>
<td>Actuarial judgement used to set assumptions.</td>
<td>Actuarial judgement might be restricted in setting assumptions.</td>
<td>n/a</td>
</tr>
<tr>
<td>-----------------------------------------------</td>
<td>---------------------------------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------------------------</td>
<td>----------------------------------</td>
</tr>
<tr>
<td>Pass/Fail Criteria</td>
<td>Actuarial judgement used to set pass/fail criteria. Because simplifying assumptions are not used, no error margin need be built into the test.</td>
<td>Actuarial judgement possibly used to set pass/fail criteria for product. Some error margin may be required in the test to cover errors introduced by not recognizing aggregation across products.</td>
<td>Little or no actuarial judgement allowed in setting pass/fail criteria. Significant error margins required in test to cover errors introduced by simplification of assumptions and test.</td>
<td>n/a</td>
</tr>
<tr>
<td>How Time Consuming, Costly and Complex</td>
<td>Most time consuming. Complexity means most companies could not do this more frequently than once a year. Costly because an actuary must set the assumptions and perform the testing.</td>
<td>Fairly time consuming and complex. Also costly as this method is also heavily dependent on an actuary.</td>
<td>Easier, quicker to perform. Less time-consuming. Likely that assumptions will be set by actuary, but test could possibly be performed by non-actuary.</td>
<td>Less time consuming, complex and costly since no testing required.</td>
</tr>
<tr>
<td>Ability to independently verify compliance.</td>
<td>Fairly complex to verify compliance.</td>
<td>Complex to verify compliance.</td>
<td>Easier to verify compliance.</td>
<td>May be easier to verify compliance for numerical disclosures; narrative disclosure language subjective to verify.</td>
</tr>
<tr>
<td>Recognition of risks for annuities identified in Academy DWG 12/5/97 report.</td>
<td>Recognizes all the risks identified for annuities explicitly in testing.</td>
<td>Recognizes all the product-level risks, but may simplify some (those that are less important for annuities) and add error margin to test to cover simplification.</td>
<td>Focus primarily on product investment risks, lapse risks, and other major risks.</td>
<td>May describe some or all of the underlying risks.</td>
</tr>
<tr>
<td>Certification What:</td>
<td>That testing was performed in accordance with guidelines, and that the block of business tested passed the relevant criteria for illustration supportability.</td>
<td>That testing was performed in accordance with guidelines, and that the product passed the relevant criteria for illustration supportability.</td>
<td>That testing was performed in accordance with guidelines, and that the product passed the relevant criteria for illustration supportability.</td>
<td>Certification that supportability disclosure requirements were met.</td>
</tr>
<tr>
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<td>----------------------------------</td>
</tr>
<tr>
<td>By:</td>
<td>Actuary</td>
<td>Actuary</td>
<td>Actuary or Responsible Company Officer</td>
<td>Responsible Company Officer</td>
</tr>
</tbody>
</table>
Appendix C: Report on Dynamic Aggregate Testing Methods

The Academy DWG has reviewed rigorous testing methods for annuity supportability. The purpose of this work was to provide a theoretical basis for looking at annuity supportability. This can be used to provide a target, or benchmark, for the Simplified Bright-Line Test methods and Supportability Disclosure methods. The following example describes one possible way to approach a test under this method.

**Example of a Dynamic Aggregate Test**

This example can be viewed as applying the concepts of asset adequacy analysis to anticipated new sales in the upcoming year, possibly with different pass/fail criteria and different assumptions. Under this example, testing could be aggregated across all products, or across selected blocks of business. The process begins with the definition of all the assumptions relevant to the business, such as the product design features, investment strategy, mortality, lapse and expense rates, tax requirements, etc. Dynamic testing of the assumptions would be required, particularly of the investment and lapse assumptions. The pass/fail criteria for illustration supportability could be set by the illustration actuary in accordance with actuarial standards. Cash flows would typically be projected along multiple scenarios to ensure that the illustration pass/fail requirements are met. The actuary would certify that the testing was performed, and that the block of business tested passed the criteria set for illustration supportability.

This methodology is not unique to annuities; in fact, it could be used for any product marketed. The testing process would remain the confidential work of the company. This example is similar to the valuation actuary testing, but would require modifications to that process.

**Strengths**: The test in this example measures the company’s viability and its ability to pay the benefits illustrated. An illustration actuary would be required to explicitly identify and test all the material risks for the block of business being tested, including the risks identified for annuities in Appendix A of this report. The test in this example would allow a company to illustrate gains from synergies created by managing blocks of business whose risks complement each other.

**Weaknesses**: The test in this example is the most complex, time-consuming, and costly of the examples described in this report. It would require significant development time before it could be included in a regulation. It would also take significant time for companies to implement and maintain. It could have a very high level of reliance on an illustration actuary to set both the assumptions and the pass/fail criteria. Aggregation of products allows for cross-subsidy between products or issues years, i.e. a given product may not be self-supporting on a stand alone basis. The time requirements for this process mean that this testing method would likely be completed
no more frequently than once a year. Also, it may be difficult to anticipate the level of new sales for the upcoming year, which may introduce error into the testing.
Appendix D: Report on Dynamic Product-level Testing Methods

The Academy DWG also reviewed rigorous testing methods for annuity illustration supportability at the product, product line, or policy form level. These methods are viewed as between the dynamic aggregate methods and the static simplified methods on our spectrum of methods.

Examples of a Dynamic Product-level Test

This example is essentially the same as the example given for the dynamic aggregate methods, except that the test is applied only to a particular annuity product being illustrated. All the assumptions will relate directly to the product being tested. Dynamic testing would be preformed, and illustration supportability pass/fail criteria could be set by the illustration actuary in accordance with actuarial standards. Some simplification of assumptions or methodology could be made; for example, the number of scenarios might be reduced.

Strengths: The test in this example forces each product to be self supporting, as it measure a product’s viability to pay the benefits illustrated. It explicitly tests all the material product-level risk for annuities identified in Appendix A of this report.

Weaknesses: The test in this example is complex, time consuming, and costly. Other financial measurements (such as statutory reserving and valuation actuary testing) are assumed to test the ongoing viability of the company and the strain from other products, neither of which are explicitly tested under this example. Test results may be sensitive to the allocation methods used for assets, expenses, and other items, possibly resulting in a need to introduce margins in the pass/fail criteria. Because the test design excludes the synergies developed under combinations of products, it may unnecessarily limit the company’s ability to illustrate benefits that are supportable. The test in this example would require significant development time before it could be included in a regulation and would take significant time for companies to implement and maintain.
Appendix E: Report on Static Simplified (Bright Line) Testing Methods
Of the American Academy of Actuaries Disclosure Working Group

Challenge of Static Simplified (Bright Line Test) Development

The primary challenge for developing a static simplified test involves distilling many complex and interacting pieces down into just a few key components. Such simplified tests usually also have very specific pass or fail criteria, which is why they are frequently referred to as "bright line" tests.

Such simplification also creates a second challenge: To identify an appropriate level of error margins to ensure reasonable results for a variety of product designs and for company specific situations. Simplification often makes a test more mechanical, which means there is less opportunity for actuarial judgment to guide the determination of supportability.

Key Points and Risks

Academy DWG discussions identified three key points in an annuity's life that should be considered in static simplified supportability testing of illustrated benefits. Also, for each key point, different risks need to be considered. The key points and risks are:

1. Early Terminations
   Risks: - Recovery of issue expenses
         - Market value losses due to asset / liability mis-match

2. Terminations Near the End of Surrender Charge Period
   Risks: All the risks for early termination plus:
         - Increased capital costs due to risk based capital requirements
         - Lower earned interest rates due to the impact of asset/liability matching requirements on reinvestments
Appendix B: Attributes of Possible Supportability Methods for Annuity Contracts Illustrating Nonguaranteed Elements

3. Longer Term Future Values (cash value and annuity payouts)
   Risks: All the risks for early terminations and terminations near the end of the surrender charge period, plus
   - Recovery of issue expenses for annuity payouts
   - Supportability of benefits due to higher persistency
Appendix B: Attributes of Possible Supportability Methods for Annuity Contracts Illustrating Nonguaranteed Elements

Bright Line Test Methodology Examples

Three methodologies were discussed that start to test for some or all of the key points and related risks. All three approaches need more research.

1. **Annuity Version of Life Self-support and Lapse-support tests**

   **Description:** This is essentially the life tests applied to annuities. It incorporates the same factors, such as persistency, mortality, expenses (issue and maintenance), taxes, etc. Some possible modifications to be considered include: i) development of an annuity version of the generally recognized expense table; ii) changing the life test's break even year from 15 to an earlier year for annuities (which may be partially driven by the level of surrender charges remaining); or iii) including a brief description of the interest rate allocation methodology in the annual certification to the Board of Directors and the Insurance Commissioner.

   **Strengths:** It is consistent with the life self-support and lapse support tests. It tests for the expense recovery and persistency risks under longer term future values (key point #3 above). This is accomplished through the 100% persistency assumption in years five and later. This stress test demonstrates the supportability of both future cash values and annuity payout benefits. Also, it is much simpler compared to the dynamic methods discussed by the Rigorous Testing Subgroup (discussed in their report, contained in Appendix B).

   **Weaknesses:** It assumes the initial earned interest rate continues indefinitely and that capital costs should be excluded, which means no testing is done for many of the risks under the key points #1, #2 and #3. Specifically, risks that may not be tested include: i) the supportability of early cash values due to risks from issue expense recovery and market value losses due to asset / liability mis-match; and ii) the impact of the surrender charge wearing off (with increased capital costs due to risk based capital requirements and lower earned interest rates due to the impact of asset / liability matching requirements on reinvestments). Also, GRET tables may be challenging to develop and appropriate time would be needed.

2. **Simplified Annuity Supportability and High Lapse Stress Test**

   **Description:** This approach also uses accumulated cash flow tests. First, it could use a pricing-like supportability accumulation, similar to the life self-support test. Factors that may be reflected include persistency, mortality, expenses (issue and maintenance), taxes, etc. Second, a stress test could examine the ability of the supportability accumulation to withstand adverse changes, such as higher lapses combined with a sudden increase in interest rates.
For example, in one particular test proposal, lapses are assumed to double and, immediately after the investment of the initial proceeds, interest rates are assumed to jump 2%. All other assumptions could be held static. This proposal is sensitive to the investment duration used by the company, as well as to the anticipated lapse pattern.

**Strengths:** It can be designed to test for early terminations, key point #1, and the related risks of the recovery of issue expenses and market value losses due to asset / liability mis-match. Also, such a test appears to be simple and familiar for those familiar with pricing, cash flow testing, or the life self-support tests. It may be able to achieve a simplistic stress test for the most significant type of interest rate risk in single premium annuity products.

**Weaknesses:** Current proposals only consider increased lapses for stress testing. It would not explicitly stress test two of the key points identified for annuities: i) terminations near the end of surrender charge period, with risks related to increased capital costs due to risk based capital requirements and lower earned interest rates due to the impact of asset / liability matching requirements on reinvestments; and ii) longer term future values (cash value and annuity payouts), with risks related to the recovery of issue expenses for annuity payouts and the supportability of benefits due to higher persistency. Some of these points can be overcome by developing additional stress tests for other scenarios. However, this increases the complexity involved in completing the tests.

3. **Annuity Margin Approach**

**Description:** This proposed approach is very different from the usual actuarial analysis. Its focus is the margin between the earned rate and the credited rate. As currently defined, this margin is the only "source of income". The proposal essentially requires a stress test of 100% of the business behaving exactly the same (i.e., all electing the same benefit at the same time). Because this test criteria prevents inclusion of any subsidies or losses from any other year or benefit, passing the test would means that all tested years and all tested benefits are self-supporting.

The current proposal uses a simplified list of "expenditures". It includes certain issue expenses and illustrated bonuses. For simplification purposes, it excludes items like maintenance expenses and federal income tax. Also, the proposed test criteria based on 100% of the policyholders electing the same benefit at the same times means that persistency assumptions are not necessary.

To estimate the impact of asset / liability matching requirements, the current proposal uses a standardized reduction in the earned interest rate based on the remaining level of surrender charges.
The cost of capital would also be included in the current proposal and would be calculated specifically for the product being tested. As proposed, it would be based on risk based capital requirements for the assets supporting the product and the factors related to the product itself. Some of the factors that would be considered include the surrender charge level, the surrender charge duration, and the payout period illustrated.

**Strengths:** The idea underlying the Annuity Margin Approach is to use what most companies measure for managing their annuity products -- the interest rate margin (or spread). With further research, it may be able to address key points #2 and #3 and almost all of the related risks, including: i) terminations near the end of the surrender charge period, including risks associated with the recovery of issue expenses, market value losses due to asset/liability mis-match, increased capital costs due to risk based capital requirements, and lower earned interest rates due to the impact of asset/liability matching requirements on reinvestments; and ii) longer term future values (cash value and annuity payouts), including the risks related to recovery of issue expenses for annuity payouts and supportability of benefits due to higher persistency. Also, because it uses one calculation that incorporates into the pass or fail criteria a "stress test" of 100% identical policyholder behavior, separate stress test scenarios may not be needed. This may result in a relatively easy and quick test, which might allow for a more frequent review of new sales interest rates. Thus far, the proposed test appears to provide a reasonable approximation to more complex annuity supportability testing.

**Weaknesses:** As proposed, it blends standardized assumptions and product specific requirements, which may not work well for all products or companies. Also, it uses only the margin generated by the supporting assets and as proposed is not based on a projected levels of assets. This means the test is less stringent on products in the early years and much more conservative in the later years. Since the pass or fail criteria may apply only after a certain year and not to earlier years, the proposal of assuming 100% of the business behaving the same way means losses from early lapses are not in the accumulations used to test later payments. Standardized earned interest rate reduction assumptions may not reflect actual experience related to asset/liability duration changes due to reinvestment. The test is much more mechanical than other tests considered and has fewer opportunities for actuarial judgment to determine product supportability.

Because it is such a different approach, more research and discussion is necessary before it can be determined whether the proposed test methodology is viable for a variety of product designs and interest rate environments.
Appendix F: Report on Supportability Disclosure

The American Academy of Actuaries Disclosures Working Group was charged with the task of evaluating the concept of “supportability disclosures” as an alternative to quantitative supportability tests. The following list of examples of different types of “supportability disclosures” is intended to provide a feeling for the breadth of ideas that fall within this approach. It is not intended to imply any preference for any method.

Supportability Disclosure - “Narrative” Examples

Example 1: Disclaimer in Narrative Summary and Customer and Agent Certifications

The NAIC Life Insurance Illustration Model Regulation requires illustrations under certain circumstances. The assumption underlying the required illustration is that currently illustrated nonguaranteed elements will continue unchanged for all years shown. This assumption is required to be disclosed in the Narrative Summary to the policyholder along with the statement that “This is not likely to occur, and actual results may be more or less favorable than those shown.” The soon to be adopted Illinois version of the Illustration Regulation goes a step further and requires that the prospective policyholder sign a certification acknowledging an understanding of the assumption, as described above, underlying the illustration. In addition, the agent must sign a comparable certification that the policyholder was made aware of the assumption underlying the illustration. The certifications are examples of supportability disclosures.

Example 2: Marketing Material with “Balancing Language”

The recently released Report of the American Academy of Actuaries Equity Indexed Products Task Force contained several recommendations concerning marketing material and illustrations. One of the major recommendations dealt with the idea of “balancing language.” Balancing language is the term used to refer to the recommendation that both the negatives and positives of product features are described for consumers. Several examples of situations in which balancing language might be appropriate, along with examples of balancing language, were provided in the Report.
Appendix B: Attributes of Possible Supportability Methods for Annuity Contracts Illustrating Nonguaranteed Elements

The idea of “Balancing Language” can be applied in any advertising or illustration situation. For example, it can be used with deferred annuity illustrations that show possible future periodic payments based on nonguaranteed elements.

Balancing language can be considered another form of supportability disclosure.
Appendix B: Attributes of Possible Supportability Methods for Annuity Contracts Illustrating Nonguaranteed Elements

Example 3: “Risks” Disclosure

This example comes from the field of securities. The use of ideas from the securities area should not be construed to mean that annuities are securities. To the extent that both types of financial products share common elements, similarity in disclosure requirements should be explored. The primary disclosure vehicle in a securities transaction is the prospectus. The prospectus is required to discuss various risks associated with the product. Such a disclosure acts as an additional disclosure by discussing the factors that have an impact on future values. In the context of annuity illustrations, factors such as changes in prevailing interest rates, changes in investment strategy, better than expected persistency, changes in profit margins, changes in the rate of inflation or some other index, and higher than expected expenses could be discussed from the standpoint of potential risk to the customer.

The following list of “Advantages and Disadvantages” applies to the Narrative Class of Supportability Disclosures.

Advantages:

Flexible enough to be applicable to both current and new policy designs and all policy features including some of the more subtle ones. Hence, the approach is less apt to be gamed by new designs (all narrative examples).

The narrative component of a disclosure-based approach may be an attractive supplement to numerical displays since it may be less intimidating to customers who may be “mathematically challenged” (all narrative examples).

Certification disclosure somewhat ensures that the customer has recognized that future policy values will probably not be as shown in the illustration (Example 1 only).

Balancing language allows the customer to see both the positives and negatives of the product, aiding them to make a decision (Example 2 only).

Risks disclosure provides information on a complete set of factors that can impact the future policy values (Example 3 only).

Risks disclosure explains the risks of annuity plans that are not necessarily specific to a product; allows the customer to be made aware of the various types of risks that cause the policy values to be different than even what is considered “reasonably” expected (Example 3 only).
Disadvantages:

For some consumers, narrative disclosures may be less explanatory than numerical displays (all narrative examples).

Company implementation of supportability disclosure requirements may be less uniform than traditional numerical disciplined illustrations (all narrative examples).

Certification disclosures may introduce administrative “issues”; when do the applicants sign, return, etc., the certification. Does non-receipt of the certification delay issue (Example 1 only)?

Balancing language can result in undue weight being given to immaterial issues (Example 2 only).

Balancing language and risks disclosure are subjective methods that may generate more regulatory involvement. With increased regulatory involvement, there is greater opportunity for state variations, which can complicate administration (Examples 2 and 3 only).

With risk disclosure, the consumer cannot quantify the risks presented, making it difficult to assess each risk’s level of pertinence, which may vary by consumer (Example 3 only).

**Supportability Disclosure - “Numerical” Examples**

Example 4: Disclosure of First Year and Renewal Year Crediting Rates

The next example of a supportability disclosure has been suggested by some regulators but, as far as we know, never implemented. The basic idea is for insurers to disclose historical first year and renewal crediting rates on products similar to the product under consideration by the consumer. The motivation behind this type of supportability disclosure is to provide assurance to the policyholder that the illustration being provided is not merely part of a “bait and switch” scheme.

Displaying first year and renewal crediting rates for successive generations of issue periods may help the customer evaluate whether the initial crediting rate is simply part of a “bait and switch” strategy or whether it is supportable over future policy
periods. However, supportability is dependent on investment returns which are not captured in the display suggested. One way of dealing with this shortcoming is to add to the matrix of first year and renewal crediting rates, data on 5 year on-the-run Treasury rates.

While this type of supportability disclosure has, to our knowledge, never been required or mandated by any state, this type of information has been published in the trade press. The November 1997 edition of Best's Review - Life/Health Edition provided historical initial and renewal crediting rates for 88 insurers on their leading plan available five years ago.

Advantages:

Supportability disclosures based on historical crediting rates may be a used tool to identify insurers who employ “bait and switch” tactics.

Disadvantages:

Supportability disclosures based on displays of actual historical crediting rates may generate customer questions that are difficult to answer by the sales force.

Supportability disclosures based on displays of historical crediting rates may make it difficult for new companies to enter certain markets due to a lack of historical data.

Who decides/regulates whether the product being used to show rates is similar enough to the proposed product? This could be open to interpretation and result in different state interpretations or gamesmanship by companies. What are the ground rules for determining what is “similar” and for those products that have no “similar” predecessor, what information will be (if any) required to be shown? This method will generate more regulatory involvement.

This type of disclosure focuses on the intent of supportability and not the ability to support the numbers displayed in the illustrations.

This method may be inappropriately used for interpretations of the illustrations that are inaccurate regarding intent, and may result in an over-interpretation of results.
Appendix B: Attributes of Possible Supportability Methods for Annuity Contracts Illustrating Nonguaranteed Elements

Practical issues: how to apply to equity-indexed, 2-tiered, interest-indexed, and flexible premium products; for declared rate products, which renewal rate at point in time can be used (i.e., the highest renewal rate over the last year, 6-month period, or month), or an average of all the renewal rates declared for the product over the last year, 6-month period, or month. If an average is used, then disclosure of such rate could be misleading since it may not be the actual renewal rate applied to any policy during the time period. Even more complication is added when different 1st-year rates apply to the same renewal rate, or where renewal rates vary by month and year of issue.
5-year Treasury rates may be somewhat appropriate for first-year credited rates, but really have no relationship to renewal rates. In fact, there could be the case where 5-year Treasuries at high rates are rolling off out of the portfolio lowering the overall portfolio rate even if current rates are rising (i.e., there is a substantial lag between current rates and what the portfolio may being earning resulting in no real correlation between the current 50-year Treasury rates and the portfolio rate).

This method could lead to lengthy disclosure (especially for products with renewal rates that can potentially change on a monthly basis) that could lead to more confusion for the customer.