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Report of the Nonforfeiture Improvement Work Group

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American Academy of Actuaries
Nonforfeiture Improvement Work Group

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REPORT OF THE NONFORFEITURE IMPROVEMENT WORK GROUP

August 2011

Developed by the Nonforfeiture Improvement Work Group
of the American Academy of Actuaries

AMERICAN ACADEMY *of* ACTUARIES

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2011 Nonforfeiture Improvement Work Group

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Executive Summary and Recommendations

This report is prepared in response to the charge assigned to the Academy Nonforfeiture Improvement Work Group (WG):

"*Study the feasibility of a new nonforfeiture law for life insurance and annuities to replace the existing nonforfeiture standards. Provide quarterly status reports on this project.*"

Two terms used in this Executive Summary and the report that follows need further commentary:

"Nonforfeiture benefit" – The benefits in kind available to a policyowner when required premium payments are no longer being made and the policy remains in force.

"Cash surrender value" – the term used to define the amount, if any, payable in cash to a policyowner at the time the policy is discontinued.

Current minimum nonforfeiture mandates treat any policy cash surrender value as a nonforfeiture benefit. The recommendations for nonforfeiture reform presented in this report consider any policy cash surrender value as a separate and distinct option under the policy rather than as a nonforfeiture benefit under the policy. All references to nonforfeiture benefits in this report should be construed to exclude any policy cash surrender value.

In this report, the WG makes certain recommendations with respect to life insurance and annuity nonforfeiture mandates and sets forth certain items for further discussion. The recommendations in the report are based on the conclusions of the WG:

1) existing minimum nonforfeiture value mandates are inadequate to meet the needs of regulators, consumers and industry in today's dynamic life insurance and annuity market, and

2) consumers would benefit from nonforfeiture mandates that are more transparent and adaptable to the ever-changing product environment.

The WG's specific ***recommendations*** are:

- Current life insurance and annuity minimum nonforfeiture mandates should be replaced with a revised methodology for determining required policy nonforfeiture values.

- Required nonforfeiture values should be determined using a retrospective methodology utilizing actual policy gross premiums and reflecting the funded portion of the risks assumed by the company under a policy.

- The required nonforfeiture value methodology should be consistent for life insurance and annuity policies.

- Required nonforfeiture values should include amounts for non-guaranteed elements in excess of the policy guarantees, including, for purposes of this report, dividends that have been declared by the company and included in policy values.

- Enhanced methods of consumer information (relative to that provided today) should be developed for consumers as part of the proposed required nonforfeiture value methodology.

- Appropriate, timely and relevant nonforfeiture basis information should be provided to regulators to facilitate oversight of the application of the proposed required nonforfeiture value methodology.

The WG recommends the following ***issues for discussion and/or resolution*** as part of implementing a revised approach to life insurance and annuity nonforfeiture mandates:

- Whether cash surrender values should be mandated for life insurance and annuity policies when prefunding is present.

- What, if any, guardrails should be placed on the nonforfeiture basis assumptions used in determining required nonforfeiture values.

- How any tax issues associated with the proposed nonforfeiture methodology should be resolved.

Overview and Charge

In 2007, the NAIC Life and Health Actuarial Task Force (LHATF) included in its annual list of charges:

"Study the feasibility of a new nonforfeiture law for life insurance and annuities to replace the existing nonforfeiture standards. Provide quarterly status reports on this project."

LHATF requested the American Academy of Actuaries (Academy) to proceed with the effort to assist it in completing this charge. It is worth noting that similar charges have been undertaken by LHATF a number of times in the past, over a period dating back almost 20 years. As with any effort of the magnitude envisioned by the language of the charge, the ability to accomplish the charge was subject to many influences not directly associated with the actuarial effort involved such as other more pressing LHATF priorities, regulatory and industry indifference to revising nonforfeiture mandates, and the slowness of product innovations in the marketplace that consequently lessened the pressure for revision.

The currently constituted Academy Nonforfeiture Improvement Work Group (WG) believes that now is the opportune time to revisit life and annuity minimum nonforfeiture mandates. This report outlines the historical roots of the current nonforfeiture mandates, sets forth the reasons that these are no longer the most optimal mandates for the current insurance and annuity marketplace, and proposes a framework and approach to reform. The effort to implement reform is significant, but the WG feels it is essential.

The WG believes that regulators and consumers would benefit from a nonforfeiture approach having an emphasis on principle-based standards rather than on rule-based standards. Properly implemented, a principle-based approach to the determination of required nonforfeiture values should provide values more appropriate to the consumer's needs.

Terminology and Conventions Used in this Report

In preparing this report, the WG has incorporated the use of certain terminology and abbreviations in communicating its ideas and recommendations with respect to nonforfeiture mandate reform. Where first utilized in this report, abbreviations are defined but, in addition, these are summarized below together with the terminology to define certain terms in a consistent fashion.

"Cash surrender value" – the amount, if any, payable in cash to a policyowner at the time the policy is discontinued.

"GPNM" – The Gross Premium Nonforfeiture Method for determining the RPNA as set forth in this report.

“NFB” – The Nonforfeiture Basis for the policy as articulated in the policy. These include the guaranteed mortality, interest, and expense assumptions, as well as any other risk charge assumptions, used in determining the amount of policy prefunding and excludes the values of any NGEs, including dividends, declared by the company, in excess of the guarantees for the policy.

“NGE” – Non-guaranteed Elements such as interest, COI rates, expense charges, and, for purposes of this report, dividends, the values of which may be in excess of the NFB guarantees. Such excess values are included in determining a policy’s RPNA once declared by the company and credited or charged according to the declaration.

“Nonforfeiture benefit” – The benefits in kind available to a policyowner when required premium payments are no longer being made and the policy remains in force. The nonforfeiture benefit at any time is equal to the RPNA using the NFB specified in the policy.

“Policy” – the contract entered into between the policyowner and the insurer to provide life insurance or annuity benefits; includes information specific to the particular policyowner and insured or annuitant under the contract as well as the more general contract provisions.

“Policyowner” - the owner of a life or annuity policy and the premium payor.

“RPNA” – The Required Policy Nonforfeiture Account for a policy; the prefunding value of the policy based on the actual nonforfeiture assumptions (NFB) articulated in the policy and reflecting the value of any NGEs in excess of the NFB guarantees.

“Threshold” – A limitation on an amount intended to represent a level deemed appropriate for the particular purpose, as chosen by all parties discussing the issue. This level is not to be necessarily deemed a “de minimis” level which is more appropriately described as something so small, miniscule, or tiny as to be of no consequence financially.

Section I

Impetus for Nonforfeiture Reform

Historical Perspective on Nonforfeiture Mandates[1]

The NAIC Model Standard Nonforfeiture Law for Life Insurance (SNFL) was adopted in 1942 and the NAIC Model Standard Nonforfeiture Law for Individual Deferred Annuities (SNFLIDA) was adopted in 1977. Both Model Laws have been occasionally amended to react to emerging changes to historical product types and their provisions have been extended to apply to new products (e.g., variable annuities, variable life, universal life, modified guaranteed annuities, etc.) through various regulatory mechanisms.

The Model Laws remain in their original basic form and not only have not been applied consistently across plans but also have not been applied consistently across all jurisdictions (a case in point here has been the inconsistent application of the "prospective" test in the SNFLIDA). The latter is often the result of regulators attempting to adapt the laws to changes in the marketplace. Since the introduction of these Model Laws, the business environment for insurance companies and their products has changed dramatically in terms of consumer needs and preferences, the lowering of competitive barriers between insurers and other financial services companies, the introduction and use of new financial instruments, and increased administrative capabilities through technological developments. This suggests the need to revisit the existing nonforfeiture requirements in a way that will allow insurers to address conditions of the 21st century.

The thrust of the needed changes is to facilitate innovation in product design that benefit the consumer while also providing adequate protection of the insurer's ability to operate profitably. The changes needed consist of a reduction in unnecessary design constraints and the elimination of requirements for values that do not reflect the true economics of the policy (e.g., mandatory "one-size-fits-all" acquisition expense allowance). Since the purpose of nonforfeiture laws is consumer protection, any revision to the Model Laws must continue to assure that appropriate protections are in place. To move beyond the current rule-based laws, it will be necessary to establish a sound set of principles that will serve as the foundation for any revision.

Changed Business and Product Environment

The business and product environment has changed for insurance companies since the existing nonforfeiture laws were put in place. Consumer awareness and lifestyles,

[1] This section of the report provides only a passing reference to the historical context of nonforfeiture mandates. For additional reference, Appendix A, An Historical Perspective provides extensive detail on the origin of and rationale for the nonforfeiture mandates in place today.

competitive pressures, product designs, and technology have progressed in ways that were unanticipated when nonforfeiture laws were formulated.

- Consumers value flexibility in the products they buy and convenience in dealing with providers of financial services. Customized and personalized solutions for all types of consumer needs are far more common today than they have been historically, and the trend is certain to continue. Consumers are also more interested in learning about the products and services they are buying, in order to make more informed choices. All of this is magnified by the importance placed on individual retirement planning by the mobility of the job market, increased longevity and demographic changes, and the transition from defined benefit pension plans to defined contribution structures.
- The existence of a secondary market for life insurance contracts, although not a substitute for required nonforfeiture values, has provided additional options to consumers that did not exist even a decade ago.
- New life insurance and annuity products that satisfy consumers' changing needs and desires have emerged since the enactment of the Model Laws. For example, universal life and variable universal life have been available for several decades, and forms of these products with premium guarantees have been very popular for a decade or more. Also, level premium term insurance products, some with premium guarantees as long as 30 years, have had significant market acceptance since the 1980's. Also, many deferred annuity products now incorporate Guaranteed Living Benefit features.
- Competition from other financial services providers has increased due to deregulation in those sectors, allowing these providers to develop and successfully market non-insurance products with characteristics similar to those offered by insurers but not subject to nonforfeiture or corresponding requirements (e.g., bank CD's).
- Technological changes have made it possible to value and administer increasingly complex products. They also facilitate improved communication with consumers, a requirement for some of the flexible products encountered today.
- Principle-based reserves are bringing a conceptual shift to how the risks to which life insurers are exposed are measured. A parallel shift in the methodology for determining required nonforfeiture values is consistent with this enhanced approach to risk management.

Constraints of Current Standard Nonforfeiture Laws

The NAIC Model Standard Nonforfeiture Law For Life Insurance and NAIC Model Standard Nonforfeiture Law For Individual Deferred Annuities (both subsequently referenced as SNFL in this report) were developed when fixed premium policies with book value benefits were the norm and asset/liability management was only indirectly addressed within the insurance and annuity industry. The products that characterize the market today have more flexible premium payment options and requirements, often with market value or equity value based designs that emphasize consumer choice in funding and/or investment decision making, but with additional risks retained or assumed by the company. Certain characteristics of the current nonforfeiture requirements represent constraints that may serve to be impediments to the development of certain products and also may impose barriers to more effective asset/liability management options.

Some of these impediments are:

1. Current prescriptive approach to nonforfeiture minimums:

    - Life insurance nonforfeiture requirements are prospective in nature and assume a fixed pattern of future premiums. Many products today are flexible premium and, in part and to varying degrees, retrospective in their operation. This makes demonstrating the equivalence between retrospective and prospective minimum nonforfeiture values dependent on arbitrary assumptions.
    - Current laws do not recognize any relationship between the value of the prefunded benefits and a product's gross premiums
    - Premium payment patterns and contractual benefit structures may dictate a cash surrender value be made available, despite the fact that this may not be consistent with the consumer's preferences or needs.
    - Nonforfeiture mandates include a smoothness test of cash surrender values that may not be easily applied to current products and is inappropriate for others.
    - Life insurance nonforfeiture mandates require a nonforfeiture interest rate for the life of the contract, which may not be representative of desirable benefit guarantees nor the investment strategy backing the benefit guarantee. The inconsistency between the nonforfeiture rate and the investments backing the contract has the potential to impose solvency strains in low interest rate environments.
    - Life nonforfeiture mandates incorporate formulaic expense levels as opposed to the specific recognition of actual company costs.
    - Mandated cash surrender values do not recognize disintermediation risk.
    - Both life and annuity nonforfeiture laws limit surrender charge patterns in a fashion that represents an expense amortization algorithm that is inflexible and does not address specific product and/or company.

2. Existing nonforfeiture mandate framework induces companies to use complex and difficult to understand product designs, such as the following, to address consumer needs:

    - The use of unusual premium scale patterns in concert with the unitary approach to reduce annually renewable term cash surrender values.

- The use of secondary guarantees in universal life policies to reduce or eliminate cash surrender values that would otherwise be required in whole life insurance policies incorporating similar guarantees.

- The Prospective Test for deferred annuities encourages the use of fixed maturity dates. This creates the appearance of a lack of flexibility for the consumer when that flexibility actually exists.

- The use of Return of Premium term products essentially similar to partial endowment products but incorporating no interim cash values. This contrasts with the nonforfeiture benefits that would be required for similar stand alone endowment products under current nonforfeiture mandates.

3. Current laws and varying interpretations result in inconsistent regulatory treatment of products with similar benefit guarantees but different contractual structures:

    - Model nonforfeiture laws are not enacted in all jurisdictions and model laws are modified before adoption in others. This will be mitigated but not resolved with the implementation of the Interstate Compact. A revised nonforfeiture mandate approach would reduce the need for varying versions of nonforfeiture mandates among the states.

    - The consumer protection value of existing nonforfeiture requirements is interpreted differently in various jurisdictions, resulting in inconsistent treatment and additional unnecessary compliance costs.

    - Insurer interpretations vary and this is not addressed consistently in the regulatory framework for current nonforfeiture mandates.

Section II

Benefits of Nonforfeiture Reform

Revising the nonforfeiture laws to better apply to the current and prospective marketplace would bring a broad array of benefits to consumers.

- Revised laws could facilitate innovation. Insurance companies could provide products that are better tailored to purchasers' needs.

- Consumer costs for insurance products could be reduced commensurate with the ability to eliminate certain risks and their costs. This could result from either the elimination of unwanted ancillary benefits that are currently required or more efficient combinations of benefits in a single product. Cost reductions are also possible due to the elimination of multiple filings currently required due to various state interpretations.

- Certain current product designs are somewhat complex to deal with under the constraints in the nonforfeiture laws. Updated nonforfeiture mandates could allow for products that are more easily understood by the consumer.

- A new nonforfeiture approach, designed appropriately, would provide increased transparency to consumers with respect to policy values and how they are determined, providing consistency in this regard with other products in the financial services marketplace.

- If constructed appropriately, a revised approach to nonforfeiture mandates will reduce the potential for complex product design features constructed primarily to comply with or avoid nonforfeiture mandates.

- Insurer enterprise risk management can be aided by allowing the design of products that are less vulnerable to economic changes.

Some of the potential benefits of a revision in nonforfeiture mandates can be identified by noting several types of products that would bring added consumer benefits, but currently are unavailable due to constraints imposed by current nonforfeiture mandates. An array of possible such products are described below. For most of these product innovations, the value to the consumer is either a more flexible policy that allows multiple needs to be addressed through one purchase decision or the elimination of undesired mandated benefits. This provides the potential for improved efficiency for consumers and insurers, and the increased efficiency may translate into cost savings.

Possible Product Innovations Under a Revised Nonforfeiture Approach

The product innovations described below are examples of products that could be made available in the marketplace with appropriate modifications to current nonforfeiture mandates. The WG is not endorsing any of these products, but is presenting this list to foster discussion of whether or not changes to current nonforfeiture mandates are appropriate. The products indicated suggest the breadth of possibilities under the most sweeping revision to these laws; however, only some are possible under the approach recommended in this report. Thus, they help put in perspective the changes being proposed. It is worth noting here that nonforfeiture mandates are primarily a consumer protection device and, under any revised nonforfeiture mandate approach, the product innovations noted below would be successful in providing appropriate consumer benefits only if coupled with enhanced disclosures to the consumer and actuarial information to regulators.

1. *No cash surrender value permanent life insurance*

   This product is not allowed under current US nonforfeiture laws. It is allowed in Canada. This type of product is currently being approximated in the US through the use of universal life with secondary guarantees. It can also be approximated through a decreasing term to 100 with a non-guaranteed element equal to the decreased amount.

   The consumer value in this product is that it could provide permanent guaranteed death benefit coverage at a lower premium. The savings result from the elimination of cash payments upon surrender (although other nonforfeiture benefits would still be provided), improved policy persistency due to the reduced attractiveness of termination, better investment returns due to lengthened liability duration and a resultant ability to invest longer, and the ability of the insurer to reduce costs with less complex administrative systems. Also, the sale is simplified and consumer understanding is increased because of the simplicity of the product (although the need for adequate disclosure of no cash surrender option cannot be overstated).

2. *Straightforward no cash surrender value term insurance*

   Many term insurance policies currently utilize high guaranteed renewal premiums and high maturity ages in order to achieve zero cash surrender values under a unitary cash surrender value calculation. Nevertheless the approach is incapable of achieving zero cash surrender values at high issue ages with the result that term insurance often is not offered above issue age 65. Without formulaic cash surrender value requirements, term insurance without cash surrender values could be offered at all ages. Also, guaranteed renewal premiums could be set at lower levels.

3. *Life insurance policies with non-smooth cash surrender values*

The wording of the "smoothness test" in the current SNFL prohibits this type of product.

The consumer benefit for this product is that cash surrender values can be generated to fit a plan designed at issue. An example is a product used to help fund college expenses. There could be no cash surrender value for 15-18 years, and then relatively large cash surrender values so that a parent can pay college tuition for a child. To the extent that cash surrender values are reduced from what would otherwise be required, there are the same kinds of savings as with no cash surrender value life insurance, although the degree of savings is reduced.

4. *Life insurance with nonforfeiture interest rate periodically reset*

The most recent revision to the Model Standard Nonforfeiture Law for Individual Deferred Annuities introduced indexing of the nonforfeiture interest rate and the capability to reset the rate using the same index at specified times during the policy lifetime. Low interest environments also affect the ability to support interest guarantees in life insurance products; consequently, there may be value in allowing annuity-type indexing of the nonforfeiture interest rate in life insurance policies. The advantage would be a strengthening of insurers' ability to address or respond to low interest rate environments.

5. *"Cash surrender value plan" life insurance*

This product is not allowed under current law, although it was given heavy consideration by LHATF as the basis for a possible revision to the SNFL in 1996-98. The concept is that the cash surrender values are not declared in advance, but rather the method for calculating the cash surrender values is stated in a "plan" that is filed with regulators and committed to by the insurer. The insurer then certifies compliance with the plan annually.

The cash surrender values that are produced by the "plan" reflect mortality, interest, lapse, or other specified experience that develops. A variation of the approach might specify a guaranteed minimum interest rate, while experience on the other factors is reflected in the cash surrender values. Another variation might guarantee a cash surrender value floor (perhaps a non-smooth pattern as discussed above) and provide experience-based benefits in addition to that on the basis of a "plan."

The value to the consumer is that a product can be structured with complete flexibility to meet consumer preferences at the time of sale. The choice of a "plan" with lower cash surrender values can potentially lead to lower premiums. As the plan reduces guarantees, the insurer can reduce risk-based capital and create savings that can be passed on to the consumer.

6. *Universal insurance funding multiple benefit types*

Universal insurance could be provided in the form of a policy with a single account value from which costs of insurance could be drawn for full levels of coverage to meet the consumer's needs in many lines of insurance (e.g., life insurance, annuity funding, annuity payouts, long-term care, or other types of insurance). It may be possible to structure the policy on a more traditional chassis while providing the multiple-line benefits. Multiple benefit policies currently are popular in Europe. In the US it is possible to receive approval for life insurance or annuity policies with ancillary benefits from other lines of insurance; however, many kinds of coverage in the secondary lines are not possible because of conflicts in laws and regulations among the various lines of insurance. Additionally, even with the limited coverages, the approach by regulators varies by jurisdiction. Examples of currently offered coverages are critical illness coverage on life insurance policies and long-term care coverages in both life insurance and annuity policies.

Consumer benefits from this type of policy could be numerous. "One stop shopping" is a convenience for the purchaser both at the time of purchase and when subsequently paying premiums or requiring customer service. The packaging of multiple coverages can encourage consumers to purchase needed coverages that they are reluctant to purchase separately. Integrated designs can make it possible to reduce costs due to the elimination of benefit overlaps. Combining coverages can reduce issue expense and administrative expense, with a resulting reduction in premium cost. For coverages that require medical underwriting, some portions of the underwriting can be shared efficiently. For lines that normally do not utilize underwriting, it may be possible to use underwriting information from other lines to justify discounts. Some benefits could be mutually exclusive and thereby reduce costs below what might occur with separate purchases. Various benefits may have negatively correlated risk profiles and thus would create a reduced aggregate risk profile that imposes less risk on the insurer and require less capital, again reducing benefit costs.

7. *Multi-generational family policy*

This product would make available all the coverages of a universal insurance policy, but also have the ability to transfer from one generation or family member to another. For example, it could be a deferred annuity for a parent, then change to a life policy on a child, and then back to a payout annuity for the parent. Concurrent multi-line benefits could also be offered. The potential consumer and insurer benefits of such a policy are similar to those mentioned for universal insurance. Additionally, there could be the opportunity to reduce aggregate costs and premiums because new sales would be replaced by intensive service, which could allow reduced sales commissions and issue expenses.

8. *Life cycle insurance*

This type of policy could provide a sequence of coverages that track the differing needs that emerge at various points in a person's life cycle. The clearest example would be a life insurance policy that changed to a deferred annuity and later changed again to an income annuity with long-term care benefits. Currently this is possible only through the sequential purchase of separate policies because of the incompatibility of life insurance and annuity nonforfeiture requirements.

This type of product would be economically efficient and would provide great convenience to the purchaser. It could "make sense" to consumers and could be popular in the market. It could be even more beneficial if there is the ability to partially convert the cash surrender value into an income stream and continue all or a portion of the life contract simultaneously (i.e., single-benefit changing to multi-benefit).

9. *Market value adjusted life insurance*

There is a model regulation (the NAIC Model Guaranteed Life Insurance Regulation) that allows for modified guaranteed life insurance that is similar to the NAIC Modified Guaranteed Annuities (MGA) model, but this regulation has not been widely adopted. Allowing a company to provide cash surrender values that reflect market value changes would enable longer duration investments and lower liquidity needs which in turn would improve policy owner value. As with other products, other non-cash surrender options would be available without market value adjustments so that the policyowner does not need to liquidate the policy if premiums are terminated. This type of provision might entail a change to the policy loan laws and regulations so that the market value adjustment is applied consistently when a policy loan is taken.

Section III

Challenges to Achieving Nonforfeiture Reform

While the WG believes that there are considerable consumer, regulatory and insurer benefits that can be realized if products can be designed without the constraints imposed by the current nonforfeiture mandates, it also recognizes that there are other laws, regulations, and practices that may present impediments to developing some of the products described previously. A strategy for dealing with these issues will have to be developed in order for nonforfeiture reform to be effectively implemented without having counterproductive results. Some of the issues that can create impediments are discussed below.

Varying Views as to the Objectives of Nonforfeiture Reform

There are various views concerning the need for and requirements of nonforfeiture mandate reform as noted below:

- Revision is needed to make nonforfeiture requirements more flexible and hence consistent with a principle-based approach to meeting consumer needs.
- Changes are needed to ensure the equal treatment of a variety of product design approaches that produce the same benefits for consumers but have different nonforfeiture requirements.
- Changing product designs will require that disclosure requirements be addressed to assure that the consumer protection aspects of nonforfeiture mandates are more directly addressed through disclosure requirements than by mandating minimum benefits.
- Nonforfeiture laws that were written between 30 and 65 years ago need to be updated to be more reflective of the realities of today's marketplace, a marketplace which is far more complex than envisioned when the laws were written.

Resistance to Change from Segments of Regulatory and Industry Sectors

- The insurance industry is not unanimous in calling for nonforfeiture revision. While there is general agreement that the nonforfeiture laws are not appropriately designed for the current marketplace environment or the evolving future marketplace, insurers have found ways to work within the constraints of the laws. While this generally requires more complex products, these insurers have found that they can continue to compete successfully. With SNFL changes, some of these products may no longer be offered. Also, any advantages of change, some feel, could be outweighed by the potential risks of adverse income tax consequences.

- Regulators generally recognize that the nonforfeiture laws need to be updated, and various efforts to this end have taken place over many years; however, these efforts have not come to fruition. It is recognized that the changes would be significant; consequently, the breadth of the change is an issue for some. The arrival of principle-based reserving has brought a heightened focus on the need to adapt nonforfeiture requirements. This is viewed as an additional catalyst for bringing nonforfeiture reform efforts to a conclusion.

Challenges To Nonforfeiture Reform Presented By Multiple Line Combination Products

The current regulatory framework in many states differs by line of business. If changes to the SNFL were made to accommodate multi-line combination products, methods to blend, integrate, or isolate the differing requirements may need to be found.

- Health insurance and property/casualty insurance are regulated in some states via loss ratios and are not subject to nonforfeiture requirements while life insurance and annuities each have their own SNFL.
- Questions arise as to what constitutes the highest common regulatory denominator for multi-line combination products.
- Life insurance and annuities typically have cash surrender values while other coverages generating prefunding may not (e.g., LTC).
- Statutory reserve requirements would need to be developed. At first glance, it may make sense to use current principle-based reserve approaches, but it would be necessary to take a closer look to assure the current proposals are appropriate.
- Premium taxe issues with respect to a multi-line combination product would need to be addressed, since these vary among lines of insurance.
- Coordination of agent licensing may need to be addressed for multi-line combination products.
- Disclosure requirements vary by line of business and would need to be coordinated.
- Rate flexibility varies by line of business.
- Risk-Based Capital (RBC) requirements vary among lines of insurance for similar risks. These would need to be integrated.
- Guarantee fund assessments vary by line of insurance and would need to be integrated.

IRS Guidelines Do Not Address the Products being Considered

In a manner similar to state regulation, the federal tax treatment of products has been product line-specific. Company and policyowner taxation issues in relation to combination products and products with reduced or flexible cash surrender values include the determination of what is considered to be life insurance, how the deferral of taxation on cash surrender value growth would be applied, and what patterns of cash surrender value development are allowable. These and other tax issues must be addressed in order for nonforfeiture reform to move forward. It's not clear what the NAIC's role would be in addressing some of these issues, but if the issues are not addressed they may become impediments to gaining universal support for change.

Section IV

Basic Framework Guiding Proposals for Nonforfeiture Reform

In its deliberations regarding the historical context for nonforfeiture mandate reform and considering the current product marketplace, heightened consumer awareness and access to information, and current regulatory practices and operational processes with respect to minimum nonforfeiture compliance, the WG felt it appropriate to establish a basic framework for reform. This framework consists of a set of criteria to guide efforts to develop an approach to reform.

The criteria below constitute the WG's framework for reform and have been developed without any attempt to impose "real world" restrictions (e.g., taxes, public policy issues, etc.) on the subject of nonforfeiture mandate reform. These criteria should apply to any proposal to change life and annuity nonforfeiture requirements.

- ❑ Nonforfeiture values should be based on prefunding resulting from premium payments and credited or charged amounts

- ❑ Nonforfeiture regulatory requirements should provide specific guidance with respect to required nonforfeiture value methodologies and general guidance with respect to the establishment of nonforfeiture value assumptions.

- ❑ Nonforfeiture requirements should incorporate a well defined and purposeful approach to any statistical agency collection of the assumptions needed to support revised nonforfeiture standards.

- ❑ Required nonforfeiture values at any time should not be representative of the economic value of the policy at that point in time but rather be a retrospectively determined measure of the prefunding of benefits accrued to that point in time.

- ❑ In determining required nonforfeiture values, there should be no recognition of a change in insurability status since the date of policy purchase, other than those that may occur as a result of the exercise of a specific policy provision.

- ❑ Nonforfeiture value methodology requirements should be the same for life and annuity products.

- ❑ The determination of non-guaranteed elements (including dividends) should not be regulated by required nonforfeiture value mandates. However, once credited or charged such amounts must be considered in the determination of any required nonforfeiture values.

Objectives of Nonforfeiture Reform Criteria

The objectives of nonforfeiture reform are to:

A. Provide product design flexibility and transparency for consumers

B. Provide a fair and equitable value to the consumer

C. Achieve homogeneous treatment of products

D. Provide long-term strategic nimbleness for the insurance industry in its product development activities

E. Remedy shortcomings in current nonforfeiture mandates for products

It is important to note that the scope of the framework for reform noted above has been limited to life and annuity products since that is the nature of LHATF's charge to the WG. The WG understands that its charge is limited to the review of current nonforfeiture mandates as they relate to life and annuity products only, but wishes to point out that the framework for reform above could be applied to other lines of business as well.

In addition, the WG recognizes that current life and annuity nonforfeiture laws apply to "individual" products only. However, the WG believes that the criteria embodied in the framework for reform above apply equally to group life insurance and annuity products where individual certificates, by whatever name, are issued. The criterion of prefunding applies based on the guarantees applicable in the contract and not on the particular chassis in which those guarantees are presented. The approach to nonforfeiture reform presented in this report makes no distinction as to the whether the policy chassis is individual or group.

Section V

Recommended Approach to Nonforfeiture Mandate Reform

General Overview

Historically, nonforfeiture mandates for individual life insurance and annuity products have established "minimum nonforfeiture values" for such policies. These values have, as their basis, the provision of a minimum nonforfeiture value predicated on certain regulated experience factors rather than the specific guarantees provided in the policy itself (although in many cases, for practical reasons, these are made the same) or the premiums paid for those guarantees. In effect, the current prospectively based minimum nonforfeiture mandates can be viewed as a retrospectively determined amount of prefunding based on the policy type and the regulated experience factors. For non-universal life insurance policies, the actual policy gross premium is not a consideration in the determination of the minimum nonforfeiture value. Also, the values of any NGEs associated with the policy (dividends, excess interest, etc.) that are in excess of the policy guarantees are generally ignored in the determination of the minimum nonforfeiture values under current mandates and so further cause a separation of the minimum values required from the actual amount of benefit prefunding accruing under the policy.

Approaches to Determining a Policy's Nonforfeitable Amount

The WG recognizes that there are various approaches to determining the appropriate nonforfeiture amount available to a policyowner should the policy terminate prior to its guarantees maturing. An overview of the other possible approaches considered, but rejected by the WG because of their inconsistency with the criteria in the framework for reform, is provided in Appendix B of this report. The WG decided that the approach that best satisfies the criteria articulated in its framework for reform is one that is retrospectively-based.

The nonforfeiture approach proposed in this report, defined as the Gross Premium Nonforfeiture Method or "GPNM," assumes that the value in a policy that is not forfeitable is any prefunding by the policyowner of benefits through premiums paid and interest credited in excess of amounts required to pay benefit and expense charges to date. The value of any NGEs that are in excess of the policy guarantees contributes to this amount. The threshold amount of prefunding above which nonforfeiture benefits must be offered is not defined in this report, and should be determined based on input from various parties. It should be noted that any decision regarding this threshold level of prefunding is independent of any decision regarding whether or not cash surrender values should be mandated when prefunding is present.

In order to better convey the concept of a nonforfeiture value based on the amount of actual prefunding accruing to the benefit of the policyowner through the payment of premiums, the WG has, as part of defining the GPNM, utilized the term "required policy nonforfeiture account" (RPNA) to clearly indicate that this prefunding value is based on the NFB articulated in the policy and declared NGE values in excess of those guarantees as opposed to a general floor or minimum guarantee based on the policy type, prescribed factors, and excluding the value of any NGEs in excess of the guarantees.

Under the GPNM, the risk charge, interest rate and expense charge structures are not regulated, beyond perhaps a broad regulatory framework. Rather this method relies upon disclosure, regulatory oversight, competitive pressures, and other market disciplines to ensure fair consumer treatment. This proposal does not consider market value changes (i.e., changes in economic conditions) or changes in health conditions (unless these are specifically provided for in the policy) as contributing to RPNA values.

Prefunding Concept

The concept of prefunding involves accumulating funds towards completely paying up the benefits promised under the policy. Once the benefits promised have been fully paid for, the nonforfeiture benefit provided becomes the benefits promised and fully funded. Examples of this process as it relates to traditional fixed premium life insurance are clear and straightforward. A 20-pay non-participating whole life policy is fully paid after 20 years, the RPNA (see below) is the amount that, with interest, will fund all future risk (mortality) charges and expense loads (based on the policy's nonforfeiture mortality, expense and interest guarantees), and the nonforfeiture benefit is the full face amount, i.e., the full contractual benefit.[2]

For flexible premium universal life, the concept is somewhat more complex but still valid. If a universal life policyowner desires, at issue, $100,000 of insurance, the RPNA is the policy account value based on the policy NFB assumptions and the values of any NGEs in excess of those guarantees. If the RPNA reaches an amount that, with interest, will fund all future risk (mortality) charges for the $100,000 benefit and expense loads, the policy is in effect paid up for the $100,000 death benefit. Thereafter, the RPNA is the account value and the nonforfeiture benefit is based on that amount.

For various types of deferred annuities on the market today, the guarantee is that, whatever the accumulated fund is when an income option is elected, a certain minimum income level per $1 of that fund will be provided. It is the purchase rates that are guaranteed, not a fixed income amount. Each premium cannot be looked on as providing funding for a specific guaranteed income. The income provided depends on how much fund has accumulated at the time income payments are to commence. Accordingly, there is no prefunding in the sense of premiums being used to fund a specific guaranteed income level. Hence, there is no nonforfeiture benefit in the sense of any promised future benefit being fully or partially funded at any time, and hence no RPNA. The portion of the fund value available to the policyowner as the cash surrender value at any time is determined by the language of the deferred annuity policy.

[2] In order to clarify the application of the GPNM to fixed level premium non-par and par WL and to demonstrate that values equivalent to minimums under current nonforfeiture mandates can be reproduced using current nonforfeiture assumptions, Appendix C of this report provides a detailed discussion of the conditions necessary for that equivalence. Appendix C demonstrates that fixed level premium WL minimum values can be reproduced as a special case of the GPNM.

Longevity annuities are the exception to this general rule regarding deferred annuities. These products, in their typical form, guarantee a certain income commencing on a certain (deferred) date. If this guarantee is paid for in one premium, the promised benefit is fully paid for and the nonforfeiture benefit is that guaranteed income. If, on the other hand, the guaranteed income is to be paid for over a period of years (typically less than the deferral period), then should the contract be terminated prior to all premiums being paid, there is a nonforfeiture benefit based on the prefunding to that date. There may or may not be a cash surrender value under the policy, but a nonforfeiture benefit and a RPNA exist. Once all premiums have been paid, the policy is fully funded with the full income payable on the contractual income commencement date.

Basic Components of the GPNM

Nonforfeiture Basis (NFB) – The actuarial basis used in determining the RPNA before the value of any NGEs in excess of the NFB guarantees. If there are no NGEs under the policy, the NFB is the actuarial basis used in determining the RPNA.

If a company has chosen to provide benefit guarantees in the form of factors (interest, COI charges, and loads) then these form the NFB. If the company has chosen to provide benefit guarantees based on the payment of a specified premium then they must declare in the policy a NFB that is consistent with the specified premium and the benefit guarantees.

Required Policy Nonforfeiture Account (RPNA) – The value that represents the actual level of policyowner prefunding.

The RPNA is calculated as the premiums paid, less risk charges and loads (expense and profit) plus interest, all on the NFB, adjusted for the value of any NGEs in excess of the NFB guarantees. The NFB assumptions may (to some degree) or may not be regulated, but are disclosed to enhance market discipline and transparency to the consumer. The NFB and any NGEs must be disclosed at issue of the contract and NGE values in excess of the NFB guarantees must be declared in advance of their being credited or charged to the RPNA. The mechanics of the RPNA are similar to the fund mechanics in a universal life policy where the amounts charged or credited must always satisfy the guarantees of the contract.

Nonforfeiture Benefits – The benefits in kind available to a policyowner when required premium payments are no longer being made and the policy remains in force. These could include reduced paid up, extended term, etc.

A nonforfeiture benefit will be required for all individual life and deferred annuity products that have greater than a certain threshold (yet to be defined) level of RPNA. See **Threshold Level of RPNA** later in this section of this report for additional commentary.

The amount of the nonforfeiture benefit will vary with, and be actuarially equivalent to, the value of the RPNA. The assumptions underlying this relationship must be consistent with the NFB as indicated in the policy for the nonforfeiture benefit chosen.

Threshold Level of RPNA

From a pragmatic point of view, there may be levels of RPNA prefunding below which no nonforfeiture benefits need be provided; the WG believes that the concept of what constitutes a "threshold" level of prefunding insofar as the RPNA is concerned is beyond the scope of this report. The materiality of the RPNA may be guided by more than just numerical considerations; it might consider elements such as perceptions of consumer fairness, political expediency, and product profitability. All of these elements may need to be considered in developing an acceptable definition of a threshold level of prefunding. The WG recognizes that the issue of forfeiture of any prefunding amount, especially if no cash surrender value is available, has public policy implications. The WG also recognizes that certain product designs currently offered involve the forfeiture of some amount of prefunding upon termination (for example, level premium term without nonforfeiture values).

Notwithstanding the above discussion, the determination of any materiality threshold with respect to prefunding amounts should be guided by certain basic criteria. The WG recommends the following be used to guide any definition of a materiality threshold level with respect to a policy's RPNA:

- The approach should not vary depending on whether the product involved provides or does not provide cash surrender values

- The approach should not favor either fixed premium products or flexible premium products

- The approach should be consistent for life insurance and annuities

- The approach should recognize the primary benefit risk(s) assumed under the contract (e.g., mortality risk, longevity risk, etc.)

- The approach should be perceived by regulators and the public as being equitable

- The approach should recognize the potential, under the GPNM to nonforfeiture mandates, for a policy RPNA to be above or below the established threshold level during the period the policy is in force and the implications, administratively, contractually, and from the policyowner's perspective, of that occurrence

There are a number of possible approaches that satisfy these basic criteria governing a threshold level of RPNA. Some possible approaches that are consistent with the above criteria are shown below in no particular order:

- ♦ Prefunding in excess of that generated by an “x”-year fixed level premium policy providing the same death or income benefits for an “x”-year period assuming the policy NFB
- ♦ Prefunding in excess of that generated by a fixed level premium insurance or annuity policy for the whole of life under the policy NFB
- ♦ Prefunding of greater than “x” annual premium(s)
- ♦ Prefunding a minimum level of mortality or longevity protection relative to the originally contracted amount

An RPNA threshold level could incorporate a hierarchical approach with various nonforfeiture benefits being triggered as the value of the RPNA reached certain levels. Although not specifically recommending that such a hierarchical approach be the preferred one used in establishing threshold RPNA values, the WG does recommend that such an approach, if utilized, satisfy a number of additional criteria:

- At the lowest threshold level, policyowners should be protected for some period of time from forfeiting their RPNA and any coverage provided
- The number of options made available should be directly related to the size of the RPNA, keeping the expense of providing the options reasonable
- The approach should recognize that, as a policyowner’s RPNA grows in value over time, the options provided by the RPNA increase

Regardless of how the RPNA threshold levels are determined, the WG recommends that the policy form contain language clearly describing the methodology for determining that amount (or amounts) and, if applicable, the options available at each threshold level.

Establishment of NFB Assumptions

The WG discussed a number of options regarding the establishment of the NFB used in determining the RPNA. For example, the elements of the NFB may be:

1) Left to the discretion of the company subject to disclosure in the policy and in other materials made available to the policyowner, in sales material, and in reports to regulators. Assumptions (i.e., the NFB) must value (i.e., fully fund) the guarantees in the contract and must be consistent with any guaranteed premiums under the contract

2) Left to the discretion of the company subject to disclosure in the policy and in other materials made available to the policyowner, and in sales material, but subject to the company demonstrating to regulators that the NFB assumptions are self supporting based on the company’s own experience or, if not available and

fully credible, a combination of company and published industry experience. The NFB assumptions must appropriately reflect the risks accepted under the policy and provide for a level of prefunding that reflects the emergence of those risks. Also, some of the elements of the GPNM may be consistent with concepts set forth in the course of implementing a Principle-based approach to reserves and capital.

3) Set and specifically defined in the nonforfeiture law or in a Nonforfeiture Manual.

In addition, information on the NFB used by companies in determining the RPNA's for their products should be provided (through a designated statistical agent) to regulators in a format appropriate to populate, on an anonymous basis, a data base (clearinghouse) of industry NFB information to be publicized to and accessed by consumers. The information should be in a form that enables the consumer to compare the NFB for their policy, either in force or prospective, with those available for similar products in the marketplace.

Additional GPNM Components

Implementation of the GPNM

In order to provide adequate time to implement the administrative, forms approval, and pricing aspects of the GPNM to nonforfeiture values, an appropriate transition period may need to be established before the revised regulatory mandates become fully effective. The length of this transition period, if any, should be established through discussions between all parties involved in the nonforfeiture reform effort.

Although the consensus of the WG is that the proposed GPNM to nonforfeiture values should apply to all life insurance and annuity contracts issued after the effective date of the nonforfeiture implementing legislation and regulations, subject to any transition period, there was by no means unanimity on this issue. The WG discussed extensively the issue of whether a "safe harbor" should be established for certain products. Under this "safe harbor," a company could elect, for the products eligible, to continue to use the current life insurance Standard Nonforfeiture Law approach, as interpreted by any applicable Actuarial Guidelines, in the determination of nonforfeiture values (RPNA values using the GPNM terminology).

Although not reaching any consensus as to the whether a "safe harbor" should be made available for certain products, the WG recommends that any product(s) subject to such a "safe harbor" be required to satisfy a clearly defined set of criteria in order for a company to elect to continue using the current life insurance Standard Nonforfeiture Law approach to determining nonforfeiture values for that product or products. The WG does not in this report recommend any particular set of criteria to be used for this purpose but does recommend that the applicable requirements be established through discussions between all interested parties, should the "safe harbor" concept be deemed a desirable component of nonforfeiture reform.

Policy Form Requirements

Every policy form would be required to describe a NFB (unless it can be shown that there is no benefit prefunding either with premiums or excess credits) and the mechanics of the RPNA must be disclosed in the policy form. For those products where the RPNA amounts are fixed at policy issue (for example, traditional whole life), the RPNA values for a certain number of years, in addition to the NFB, must be disclosed and shown in the policy form.

The WG recognizes and anticipates that, even after the ultimate effective date of any revised nonforfeiture implementing legislation and regulations, there may be products for which nonforfeiture values, and cash surrender values if applicable, may continue to be displayed in the policy in a tabular format. However, such values would need to be determined using the retrospective GPNM described in this report.

Consumer Disclosure

Since the RPNA components are not recommended to be regulated beyond a broad regulatory framework, the WG proposes that the policy's NFB be disclosed at issue. Actual charges or credits or the parameters for their determination should also be disclosed in advance. If the benefit guarantees are based on factors, then the company would disclose a premium level, based upon the policyowner's specified premium payment pattern and subject to any other premium limitations included in the policy form, which funds the policy coverage over the period chosen based upon the NFB guarantees.

The WG believes that additional consumer disclosures with respect to nonforfeiture values over those currently in place by law or regulation will be required, but the exact form of these disclosures has not yet been developed. In addition to understanding the NFB assumptions associated with their prospective purchase, the WG believes that the consumer should understand how his or her contract compares to other choices available in the marketplace. Below are some of the ideas the WG has discussed, but there are drawbacks to each of them, and in this report the WG does not endorse any particular form of additional disclosure:

- Notice of alternative product choices available from the insurer

- An NAIC-sponsored website where all insurers are allowed/required to post their product offerings for consumer inspection in a specified format

- Some form of cost disclosure showing the effective death benefit costs or non-forfeiture returns over specified time periods

- An annually updated NAIC disclosure piece that displays some form of quartile of industry guarantee, charge and cost structures that allows the consumer to compare this or her purchase to industry data

Regulatory Information

Since the GPNM represents a significant departure from historical requirements, the WG believes it will be important for the NAIC to maintain a central repository of marketplace NFBs. As regulators identify concerns in the trends of product designs, product guarantees or consumer complaints, they would have the adequate and timely information necessary to consider creating additional disclosures or other requirements intended to stem potential abuses.

Suitability

In addition to appropriate levels of disclosure, it may also be necessary to develop appropriate suitability requirements that may require minimum guarantees or other criteria for certain age groups or sales situations where the GPNM may not work optimally.

GPNM Examples

- Non-Par Whole Life – The RPNA equals the current SNFL cash surrender value when the annual RPNA expense assumption equals the difference between the gross premium and SNFL adjusted premium, the RPNA mortality charges and interest equal the SNFL basis, and the RPNA acquisition expense equals that assumed in the SNFL. See Appendix C.
- Par Whole Life – The RPNA is the same as above plus dividends credited. See Appendix B.
- Universal Life – The RPNA is equal to account value. The company can, at its option, pay out the RPNA less the surrender charge on termination.
- "Shadow Account(s)" UL Policy – The RPNA equals the greatest of the following values:
    - i) the account value produced by the base policy assumptions, including declared values for any NGEs in excess of the policy guarantees; and
    - ii) the greatest of the account values produced by each set of shadow account assumptions for the period these are in effect and the base policy assumptions, including declared values for any NGEs in excess of the policy guarantees, thereafter.
- Longevity Annuities – The RPNA equals the account value under the NFB assumptions.
- Accelerated Death Benefits – Appendix D to this report provides a description of the treatment of two types of Accelerated Death Benefit options under the GPCM

approach to nonforfeiture and the impact, if any, of the exercise of these options on the RPNA of a policy

General Observations on the GPNM

The following are some general observations with respect to the GPNM:

- If the premiums paid and NFB mortality rates, expense loads, and credited interest rates are the same for a "Shadow Account" UL policy and a Whole Life policy with the same benefits then the RPNAs are consistent.

- The methodology could be extended to multi-benefit/multi-risk contracts.

- The methodology maintains continuity with current term, whole life and UL requirements.

- The methodology places the prefunding focus on what the company chooses to declare and/or guarantee.

- The GPNM is consistent with some international frameworks (e.g., Canada).

- The methodology is a departure from the concept of maintaining equity between terminating and persisting policyowners. Rather, the GPNM focuses on defining (and disclosing) an equitable level of funding to be provided to policyowners who either terminate or complete the planned contractual risk-funding agreement (i.e., it is more a concept of earned equity).

- The retrospective GPNM, as opposed to the net premium prospective approach, achieves consistency with how deferred annuities are handled under the SNL where there is prefunding. It does not contain any self-supporting pricing requirements. The WG believes this concern should be more appropriately handed as a solvency issue rather than a product / pricing oversight issue.

- The GPNM raises the need to consider whether, and to what degree, boundaries and regulatory guidance should be imposed on NFB assumptions.

- The methodology creates a more level playing field with respect to nonforfeiture values in that it eliminates the tying of nonforfeiture values to product type.

- This method does not require any mandated guarantees within insurance contracts. The WG believes market disciplines will force those guarantees to emerge based on what an informed marketplace expects to receive as a consequence of enhanced disclosures to consumers and regulators.

Regulatory Framework for the Operation of the GPNM

As stated previously, the GPNM needs to be accompanied by a regulatory framework significantly different than that currently in place. In addition to the basic legal and regulatory underpinnings, the success of nonforfeiture reform depends substantially on enhanced policyowner disclosures and regulatory monitoring and data collection systems dependent significantly on the use of the Internet and other information technology systems. The WG strongly believes these systems are crucial to ensure appropriate regulatory and actuarial oversight and also that relevant consumer information is readily available to and well understood by both consumers and regulators.

The recommended components of an appropriate regulatory framework are:

- A new Standard Nonforfeiture law for life and annuity products
- A new Life and Annuity Nonforfeiture Manual
- Potential new regulations
- Potential new Actuarial Guidelines
- Potential new ASOPs
- Enhanced sales disclosures
- Enhanced consumer reporting mandates that make use of the Internet to make nonforfeiture information with respect to a policy available to the policyowner in a clear and understandable fashion
- Mandatory availability to regulators, through a prescribed statistical agent and utilization of the Internet, of information on the actuarial assumptions (NFB) and emerging experience used by the industry in determining RPNAs

Section VI

Issues Related to Mandating Cash Surrender Values in Life and Annuity Products

In the course of its discussions on nonforfeiture mandate reform, the WG spent a significant amount of time discussing the issue of whether or not cash surrender values should be mandated for life and annuity policies when RPNA values are present. Under the current regulatory structure, minimum nonforfeiture benefits and minimum cash surrender values for individual life products are actuarially equivalent on a book value basis and both cash surrender and nonforfeiture benefits are generally either present in a product or are not; rarely is there a product where one option is present and the other is not. The individual annuity SNL does not mandate that a cash surrender be provided under such policies but, when provided, establishes a minimum value based on the accumulation of gross premiums, less defined expense load, at the minimum nonforfeiture interest rate set forth in the law.

Although a requirement for cash surrender values when RPNA values are present is not part of the principles constituting its framework for reform, the WG was acutely aware that a decision on whether to mandate cash surrender values is a controversial one and that all parties involved would be best served by including in this report a discussion of the issue. Accordingly, this section of the WG's report discusses two areas regarding this issue: 1) if cash surrender values are mandated, the actuarial aspects of how cash surrender values should relate to the RPNA, and 2) the various pros and cons of mandating cash surrender values when RPNA values are present.

General Comments On Cash Surrender Values, If Provided, and Their Relationship to the RPNA

This segment of the WG's report addresses the determination of cash surrender values for policies that are either required to have them or for which the company elects to provide them and their relationship to the policy RPNA. It recommends there be an appropriate actuarial relationship of any cash surrender value relative to the RPNA.

Basic Assumptions

- ✓ This segment of this report does not define the RPNA or the method of determining the RPNA. It assumes a method already exists that defines the assumptions used to determine the RPNA.

- ✓ This segment of this report does not define a threshold level of prefunding. It assumes that this has been defined by the various parties involved in the nonforfeiture value reform process.

- ✓ This segment of this report does not define which policies with a defined level of threshold prefunding are to have cash surrender values. It assumes that this has been defined by the various parties involved in the nonforfeiture value reform process.

Overview and Discussion

Nonforfeiture benefits should be based on a measure of prefunding as defined by the RPNA, which is itself, according to the framework for reform, based on the gross premiums actually paid using appropriate assumptions for interest, mortality, morbidity, expenses, etc. (the NFB). The NFB is determined consistent with the policy guarantees and any regulatory guardrails. In most cases, this will be determined at the policy date of issue or the date guaranteed benefits are changed, except for the crediting of NGE values in excess of the policy guarantees.

The proposed GPNM uses a pre-defined set of NFB assumptions for credits, including interest, and charges and the gross premiums in determining the RPNA. The values of any in kind nonforfeiture benefits at any time are equal to the RPNA for that nonforfeiture benefit, using the NFB prescribed in the policy for that benefit, adjusted for the value of any NGEs in excess of the policy guarantees.

Cash surrender values should be set at a level that reflects the cost of the liquidity option inherent in their provision. In effect, this ensures that cash surrender values are set such that, in the language of the 1942 Guertin Committee Report, "…continuing policyowners will not be unduly penalized on account of the granting of excessive nonforfeiture benefits (cash surrender values) to policyowners who terminate their contracts, but the withdrawing policyowners should be granted the largest values which can be granted without violating this condition."

Policyowners who elect to take the cash surrender value render the original policy no longer in force. They do not provide a continuing source of revenue for the company and its persisting policyowners. Therefore, any relationship between the RPNA and a cash surrender value should recognize the appropriateness of the company recovering some amount from discontinuing policies so that continuing policyowners are not unduly burdened. For policies that have a cash surrender value and also have a policy loan provision, the need for liquidity is even more pronounced. As a result, allowances for these considerations should be part of any cash surrender value requirement relative to the concomitant RPNA.

Once the values of any NGEs are declared, the excess of those values over the policy guarantees becomes part of the RPNA, which also affects both the amount of the nonforfeiture benefits and any cash surrender values.

Actuarial Relationship of Cash Surrender Values to RPNA

Any cash surrender value should be set equal to the value of the RPNA using the NFB and reflecting the value of NGEs in excess of the policy guarantees, adjusted for the risks and expenses associated with providing cash on demand. The NFB are those assumptions set consistently with any required gross premium and the policy's guaranteed benefits. The actuarial adjustments to the RPNA in order to define the required cash surrender value at the time of surrender should be described in the policy and reflect the risks and expenses of providing cash on demand relative to the policy continuing in some form. The specific relationship between the RPNA and related cash surrender value actuarial assumptions should be determined at the time any available cash surrender value is elected and will vary between companies depending on the type and degree of risk to which a company exposes itself when a cash surrender option is made available (or required) under a policy.

A policy may provide for a policy loan provision if it has a cash surrender value. The WG does not recommend that all policies with a cash surrender value must have a policy loan provision. It is assumed that the maximum policy loan value is set equal to the cash surrender value and not the RPNA. The presence of an additional call option through the availability of a policy loan may justify a different actuarial adjustment relative to the RPNA than is appropriate for policies that do not contain such an option. It may also be possible to allow the maximum policy loan value to be set equal to less than the cash surrender value in order to recognize the fact that additional liquidity is needed for such a policy provision.

The types of actuarial adjustments to the RPNA appropriate in determining the cash surrender value could take various forms, including but not limited to, for example:

- Interest rate spread – an adjustment to the NFB interest rate assumption to reflect changes in the Treasury yield curve since issue of the policy; essentially a recognition of the company's exposure to the disintermediation risk under the policy

- Liquidity risk - an adjustment to the NFB interest rate assumption to reflect the market risk (saleability) associated with the assets backing the policy guarantees

- Mortality factor – an adjustment to the NFB mortality assumption; in essence, a recognition of lapse antiselection exercised by those electing any policy cash surrender value

- Expense factor – an adjustment to the NFB expense assumption to recognize that the company has lost in-force business that otherwise would help spread overhead costs.

- Unamortized initial acquisition expense factor - an adjustment that grades to zero after some number of years to recognize unamortized initial acquisition expenses applicable to the policy or contract that are not yet been fully recognized in the calculation of the RPNA value.

Since a policy could have multiple nonforfeiture benefits post-nonforfeiture benefit election, and hence multiple RPNA's, the appropriate RPNA should be used to determine any cash surrender values provided after the election of a nonforfeiture benefit.

Pros and Cons of Mandating Cash Surrender Values

Reasons For Mandating Cash Surrender Values When a RPNA is Present

1. Addresses Changing Needs

- At the time the policyowner decides to stop making premium payments that are required or necessary to keep the policy inforce, or required premium payments have been completed, coverage provided through the nonforfeiture benefits may not be wanted or needed; the policyowner may want or need the liquidity afforded through a cash surrender value.

- Cash surrender values make available the option to provide policy loan values using the cash surrender value as collateral, which is a less permanent alternative to terminating coverage when cash is needed.

- For products with substantial prefunding, the cash surrender value is the only means the policyowner has to obtain value from the contract. What may have appeared to be a good deal at issue may not appear as attractive over time. Policies with NGEs may have been purchased for the company's anticipated policy on NGEs (e.g., the prospect of being credited an attractive rate of interest) in addition to the death benefit, and the policyowner may be affected if the company's policy on NGEs changes after the policy is purchased (or if the company is subsequently purchased and the new owner changes the company's practices with respect to NGEs).

2. Avoids Undesired Exposure to the Secondary Market

- A cash surrender value allows the policyowner to terminate unneeded or unwanted insurance at a determinable value, while dealing directly with the insurance company rather than through an intermediary. Without this option, those needing cash would be subject to the conditions and constraints of the secondary (life settlement) market. Typically, the life settlement market is looking only for policies where the return justifies the work and expenses; consequently not all policies may qualify for sale in that market.

- For policyowners who do want to bid their policy in the secondary market, but do not have an independent means to value the policy, a cash surrender value may provide a point of reference or benchmark to help indicate whether or not an offer they receive is reasonable. This could become especially important if regulatory, market, or other forces lead to the secondary market becoming inefficient or uncompetitive. In that event, offers to consumers might be much less than otherwise, a result that would not necessarily be in the public's best interests.

3. Protects Less Well Informed Policyowners

- Mandated cash surrender values serve the less well informed marketplace, where consumers are less likely to understand their policy and may expect, in spite of full and adequate disclosures made to them, that they will be able to cash in their policy at some point.

- If cash surrender values are not mandated, consumers who are less well informed and who purchase policies without cash surrender values may complain to state regulators many years down the road that they didn't understand that the product has no cash surrender values (especially if some policies do and some don't). Such actions potentially put additional strain on regulatory resources. Mandated cash surrender values would minimize the potential for these problems.

Reasons Against Mandating Cash Surrender Values When a RPNA is Present

1. Persisting Policyowners Could be Hurt

- If a mandate require a company to provide cash surrender values in excess of the value of assets backing the policy, then terminating policyholders may benefit and persisting policyowners may be penalized. This situation can occur for a number of reasons, including: (1) the mandated cash surrender value requirement is high in relation to the policy asset share, and (2) the market value of the assets supporting the policy have declined versus their book value, as reflected in the mandated cash surrender values, i.e., asset values have deteriorated in value due to credit issues or interest rate spikes. Note that reason (2) may also cause a company to experience overall negative financial consequences as well.

2. Opportunity to Reduce Costs Could be Lost

- If cash surrender values are not mandated, the cost of coverage could be reduced, while cash would still be available, if needed, through the life settlement industry. However, if the value of nonforfeiture benefit provided is actuarially reflective of the underlying asset share, then the cost of providing cash surrender values is not likely to be very large. Such costs would include, for example: (1) the cost of the disintermediation (liquidity) risk; that is, the cost of holding more risk surplus and the implicit cost of having to invest shorter and in more liquid investments, and (2) losing any potential future investment gains, mortality gains and expense margins on the business surrendered. Under the GPNM, if the RPNA accurately represents the policy asset share and the additional forfeiture costs associated with providing the cash surrender value are reflected in that value, the cost of providing the cash surrender value would be nil.

3. Could Promote Industry use of Creative Designs to Produce No Cash Surrender Value Policies

- If there is no cash surrender value mandate, products with no cash surrender values could likely be designed in a much more consumer-friendly way. Mandating cash surrender values has the potential to in effect promote industry creation of complicated products with reduced or no cash surrender values, since there is likely a market for low or no cash surrender value products. Such products create regulatory challenges and can be difficult for the average consumer to understand.

4. Impractical for Some Policies

- It may be impractical to require cash surrender values that may be *de minimis* in value on some small or short-term policies.

5. Mandated Cash Surrender Values can give Consumers a False Sense of Accuracy, Appropriateness and Adequacy

- Mandating cash surrender values may give the illusion that such values provide the best deal out there for the consumer and that there are no other liquidity options available. A disconnect between what the policyholder has access to and other options (e.g., the secondary market) may be created.

6. Cash Surrender Values Would Make Insured Products Inappropriate for Certain Markets

- Benefits provided under plans made available by sophisticated and more knowledgeable sponsors may be funded using insured products, either individual or group. It would be contrary to the intention of such purchasers to utilize policies incorporating cash surrender values rather than policies required to remain in-force to provide benefits in accordance with the sponsor's plan

Section VII

The Road Ahead - Next Steps and Deliverables

This report presents the WG's development of a broad-based plan for nonforfeiture reform. It represents only the beginning of a lengthy process involving the formulation of a revised nonforfeiture law and a newly conceived Nonforfeiture Manual as well as attendant ASOPs and practice notes. Laws and/or regulations covering disclosure and suitability will need review and revision. But even before that process can begin, the WG needs critical input on the plan. The process for nonforfeiture reform cannot commence unless the proposed approach is clear and acceptable to all parties involved – regulators, industry, and consumer groups. To that end, the WG seeks input on the following items addressed in this report (in no particular order):

A. Is the GPNM an appropriate approach to establishing nonforfeiture mandates and RPNA values?

   - Validity of the criteria established in the WG's proposed framework for reform as a basis for reform
   - Effectiveness of GPNM in satisfying the criteria set forth in the WG's proposed framework for reform

B. The issue of whether cash surrender values should be mandated in life and annuity products when some threshold level of RPNA is present **(Section VI)**

   - Impact on product design and potential for reduced costs
   - Relationship to nonforfeiture values
   - Impact of secondary market activities

C. The relationship between RPNA values and cash surrender values, if available

   - Should the relationship between RPNA values and cash surrender values, if available, be mandated and disclosed in the policy?
   - If the RPNA/cash surrender value relationship is not actuarially equivalent, how should the relationship be linked?

D. The appropriate approach to regulating the nonforfeiture basis (NFB) elements **(Section V)**

   - Interaction of regulatory mandates and company flexibility
   - Consumer protection issues
   - Disclosure issues: to consumers and regulators
   - Confidentiality issues

E. The appropriate approach to handling RPNAs that are below a threshold level **(Section V)**

- Is there a need for special treatment of small amount RPNAs? If so, how should the threshold level of RPNA for providing nonforfeiture benefits be determined?
- Is a tiering approach workable, particularly with flexible premium products?

F. The period of time a "safe harbor" should be in effect with respect to current SNL nonforfeiture minimums **(Section V)**

- Should the safe harbor period for current SNL values be temporary?
- Is permanent special treatment for certain products/companies appropriate?

G. The issue of whether group life and annuity products should be subject to nonforfeiture mandates when prefunding is present

- Should they be dealt with differently; if so why?
- Is the marketplace a driver of differences?

H. The appropriate changes in disclosure and suitability requirements necessary to implementing a revised nonforfeiture mandate methodology **(Section V)**

- To what extent should the Internet be used for policyowner information on marketplace NFBs
- What information should be made available to regulatory authorities via a statistical agent intermediary?
- How can consumer disclosures be enhanced?
- Relationship between regulatory mandates and consumer information

Input on these areas, as discussed in this report, is critical to solidifying the roadmap for nonforfeiture reform as presented here. Some of the issues raised above, and others raised only peripherally in this report but which also affect nonforfeiture mandates, require discussion and input from additional parties. However, with respect to any ensuing discussion of these issues, the WG remains committed to being an active participant in their resolution. In addition, Appendix E of this report sets forth those issues the WG considers to be the significant public policy issues associated with its proposal for nonforfeiture mandate reform.

Appendix A

AN HISTORICAL PERSPECTIVE[3]

The SNFL for life insurance has not changed significantly since its adoption in 1942 and, although subject to interpretation with respect to various products over time, its basic form has changed little since Elizur Wright first introduced the concept of nonforfeiture in Massachusetts in the early 1860's. The concept of nonforfeiture and it attendant laws and regulations are a reflection of the business, consumer, marketing, regulatory and technological environment in effect at the time they are developed or enacted; consequently, the WG believes it would be instructive to review that environment over the last 150 years, how it has affected the structure of the laws, and whether today's environment warrants modification of that structure.

Insurer Practices

In the early 1860's, 90% of business sold was level premium whole life, with a significant portion of the remainder endowment or 10-pay life. These types of policies have the potential for a significant amount of benefit prefunding. A premium grace period or policy reinstatement was not required by law nor did the company generally voluntarily offer it. Policyowners were at significant risk of involuntarily forfeiting their benefits simply because of a missed premium payment. Elizur Wright was concerned that, unless nonforfeiture values were made available to policyowners who either voluntarily or involuntarily surrendered their policies, what he thought were abusive sales practices that he observed in the London markets would develop here.

This risk was further exacerbated because of the common practice of companies selling policies using "callable" premium notes. The notes, which were like loans, covered early contract year premiums in an attempt to reduce the policyowner's outlay and in turn increase sales. The issuing company held the notes. If the company called those notes and the policyowner did not pay the outstanding debt, they were forced to forfeit the policy.

During this time, companies benefited financially from significant forfeitures by policyowners living in southern states that seceded from the nation prior to the Civil War. As this source of profit eventually disappeared, companies introduced the tontine plan as a way to again benefit from lapsing policyowners, partially through the assessment of excessive expense charges. The plans were typically sold with maturity periods of 15 to 30 years. Prior to maturity the policyowner received no dividends. The portion of equity represented by the dividends was accumulated in the tontine fund to eventually be distributed, at the company's discretion, to surviving policyowners. To continue to policy maturity, the policyowner had to pay the required premiums. Agents who made what turned out to be widely optimistic predictions of the ultimate distribution appear to

[3] The information in this Appendix A is compiled from the following source documents:
(1) McClure's Magazine, Vol. 27,May 1906, pp 36-49
(2) "The History of Life Insurance in the United States to 1870," Charles Kelley Knight, University of Pennsylvania, 1920
(3) Online blog @ http://www.actuarialoutpost.com/actuarial_discussion_forum/, Chris DesRochers, 10/29/06

have been very successful at selling these types of plans. Even if excessive expenses had not been charged to the fund and fraud by the companies had not occurred, those predictions were attainable only if a significant number of policy owners forfeited their benefits by terminating premium payments.

Regulatory Responses

It is interesting to note that it was during the emergence of these tontine plans that Elizur Wright came to regret not requiring cash values as a nonforfeiture option, since cash was the primary benefit of a tontine plan that was being forfeited. A cash value requirement was added to the Massachusetts regulations in the 1880s.

The abuses of the tontine plans and the questionable company business practices led to the Armstrong investigation around 1905, which in turn eventually led to Alfred Guertin's work resulting in the Model Nonforfeiture Law proposed in 1942. A concept widely attributed to Guertin and often reiterated during today's deliberations is the idea that persisting policyowners should not be penalized by terminating policyowners receiving excessive amounts and that terminating policyholders should be provided the largest value consistent with this condition. This goes beyond the concept of nonforfeiture values being equal to the value of the policyowner's prefunded benefits and introduces the idea of a policyowner's equity in a policy. Given the link between Guertin's work and the abuses associated with the tontine plans, especially the claim that the fund would be "equitably" distributed to surviving policyowners, it seems likely that this concept of equity related more to the tontine plans rather than to a prefunding of benefits concept of nonforfeiture.

One of the lasting legacies of Elizur Wright is a nonforfeiture law today that is based primarily on prospective formulas. At the same time that he was working on nonforfeiture, Wright was also working on strengthening reserving, also based on prospective calculations. In commenting on the need for nonforfeiture values, he described a theoretical portion of a level premium that went into a "savings" account to fund future benefits. Today, because of advances in technology, it is possible for those values to be calculated and reported to the policyowner essentially in real time so it becomes viable to consider a law based on a retrospective approach.

Appendix B

Other Approaches To Determining Nonforfeitable Values Considered By the WG

Below is an overview of the various approaches to determining the appropriate nonforfeiture amount available to a policyowner should his or her policy terminate prior to its guarantees maturing that were considered by the WG. These approaches did not meet the criteria set forth in the WG's framework for reform.

1. Prospective Methods – This is a general term designed to determine a policy's value at any time as the present value of future benefits and expenses less the present value of future premiums. It is a kind of gross premium valuation approach. This methodology description is general in nature and could, in concept, reflect actual policy premiums and all benefits and expenses. Assumptions could be changed prospectively in the future (i.e., not set at issue) to reflect current economic or risk factor conditions.

   These methodologies assume that the best way to maintain a balance between persisting and terminating policyowners (a concept of equity) is to look prospectively. For participating products or products with flexible premiums and/or benefits, these methodologies raise questions about what should be assumed prospectively with regard to dividends, premiums and/or benefits. Also, the approach does not lend itself to being clearly understood by consumers nor is it readily seen as being an appropriate proxy for the value of the accrued prefunding attributable to the policy at any time, but rather has the appearance of being an economic value of the policy at that time. Also, for a prospective approach to be consistent with the criteria embodied in the WG's proposed framework for reform (see Section IV), "guardrails" would need to be imposed on the assumptions used in its application (e.g., no change in insurability status since issue).

2. Net Premium Approach – This, sometimes referred to as the "adjusted premium" approach, is the approach for determining minimum nonforfeiture values incorporated in the current Standard Nonforfeiture Law For Individual Life insurance in effect in most states. It is a special case of the prospective methodology approach where a net (adjusted) premium is used and specific mortality, acquisition expense, and interest assumptions are prescribed. In addition, these assumptions are fixed at issue and the approach requires the entire premium and benefit pattern be known at that time.

   For products with guaranteed premiums and guaranteed benefits, this concept works reasonably well but otherwise is subject to the same practical problems as the more general prospective method approach.

3. SEC Approach – This method has been raised in the past with respect to maximum charges for variable products as set forth by the SEC. The proposed method here was a retrospective approach for determining minimum policy values for these types of

products. This approach, if conceptually extended to general account products, would amount to a version of the method proposed in this report with certain elements prescribed as opposed to being based on company or industry-wide experience.

Appendix C

Treatment of Non-Par and Par Fixed Level Premium WL Under the GPNM

Current nonforfeiture mandates were developed largely using fixed level premium non-participating and participating whole life policies as their basis. Consequently, other than being determined on a prospective basis and being somewhat non-transparent in their determination, current minimum values for these products are a reasonable representation of their prefunded risks at any time. Consequently, currently mandated minimum nonforfeiture values and cash surrender values for fixed level premium non-participating and participating whole life policies can be considered a special case of the GPNM.

The RPNA values for these products, computed using the following assumptions, are equivalent to the minimum nonforfeiture values mandated under the Model Standard Nonforfeiture Law For Life Insurance:

- The RPNA is determined on an annual basis.
- The policy premiums are assumed payable annually each year on the policy anniversary date.
- The initial acquisition expense assumption for the policy used in determining the RPNA is assumed equal to the acquisition expense assumption included in the Model Standard Nonforfeiture Law For Life insurance.
- At issue, the present value of the annual net premiums for the policy is set equal to the present value of the future death benefits under the policy plus the initial acquisition expense for the policy. The net premium is the same level percentage of the gross premium for each year premiums are payable.
- The annual maintenance expense assumption used in determining the RPNA is equal to the difference between the annual policy gross premium and the annual policy net premium.
- The annual interest rate used in determining the RPNA is set equal to the maximum interest rate assumption included in the Model Standard Nonforfeiture Law For Life Insurance.
- The annual cost of insurance rates used in determining the RPNA are set equal to the nonforfeiture value mortality assumption included in the Model Standard Nonforfeiture Law For Life Insurance.

If the RPNA values are determined as above, the values may be shown in tabular form in the policy and values determined off anniversary may be determined according to methods currently in use for determining such values.

For participating whole life policies utilizing a Paid Up Addition (PUA) dividend option or Paid Up Insurance (PUA/PUI) rider and utilizing tabular values determined as above, the RPNA will also include the accumulation, on an annualized basis, of the gross premiums used to purchase the additional insurance, less the cost of such insurance and the expense charge.

- In determining the RPNA for these benefits, the PUA/PUI rider gross premium (or dividends under the PUA dividend option, since the dividend is in effect the gross premium) are accumulated at the maximum interest rate assumption included in the Model Standard Nonforfeiture Law For Life Insurance and the annual expense charge and cost of insurance are deducted.
- The expense charge each year for any PUA dividend option or PUA/PUI rider is equal to the difference between the gross premium paid in that year and the net single premium for the insurance provided.
- For the PUA dividend option, the expense charge in each year will therefore equal zero since the total dividend is used to purchase paid up additions and is considered the gross premium.
- The PUA/PUI rider gross premium (or dividends under the PUA dividend option) will be accumulated at the interest rate equal to the nonforfeiture value interest rate assumption included in the Model Standard Nonforfeiture Law For Life Insurance.
- The annual cost of insurance rates used in determining the cost of the insurance amounts provided are set equal to the nonforfeiture value mortality assumption included in the Model Standard Nonforfeiture Law For Life Insurance.

Notes:

These assumptions for the PUA dividend option and the PUA/PUI rider portion of the RPNA ensure that the additional RPNA amount at any time equals the present value of the amounts of insurance purchased to date.

Dividends left to accumulate at interest have no impact on the RPNA since they reflect no prefunding of future benefits under the policy.

Appendix D

Treatment Of Accelerated Death Benefits Under the GPNM

Some policies also provide an additional benefit for unhealthy lives, such as a lien against the policy's death benefit (e.g., an accelerated death benefit in the form of a lien). These liens can exceed both the value of nonforfeiture benefits and any cash surrender value, but the policy remains in force by the terms of the policy with the death benefit reduced by the amount of the lien In addition, these liens, by the terms of the policy, reduce the remaining amount of any cash surrender value otherwise available if the policy is terminated and they also reduce the remaining policy loan value. These liens, which are based on a change in the health status of the insured, are outside the scope of required nonforfeiture value mandates.

In contrast, accelerated benefits that are not in the form of a lien operate to allow the policy to continue as a single accounting entity going forward rather than a combination of the policy and a policy lien (two accounting entities). The policy is effectively reduced pro rata at the time of the accelerated benefit payment (premiums, cash values, and death benefit are reduced in proportion to the amount of death benefit accelerated to the full benefit). This transaction would have a direct and immediate impact on the nonforfeiture value of the policy and the language of the policy form, or benefit rider, should reflect this.

Appendix E

Public Policy Issues Raised by the GPNM

During the process of preparing its report on the feasibility of revising nonforfeiture mandates for life insurance and annuities to replace the existing nonforfeiture standards, the WG spent substantial time and effort discussing a number of public policy issues related to its proposed approach to the revision of existing life insurance and deferred annuity minimum nonforfeiture mandates. The public policy issues raised by the WG in the course of its discussions are discussed below.

Requirement for Mandatory Cash Surrender Values When a Threshold Prefunding Level is Present

The WG ultimately decided, and this decision is reflected in the body of this report, that the issue of whether, and under what circumstances, policy cash surrender values should be made available is beyond the scope of this report. The WG believes that this is a public policy issue with the final decision to be made by all parties involved in the nonforfeiture mandates revision process. This includes, but is not limited to, the Academy, regulators, consumer groups, and insurance industry groups. Such discussions also need to consider any tax consequences of the decision. The WG did discuss in this report (Section VI) the actuarial and other considerations, both pro and con, affecting any decision on this issue, in an effort to assist in framing and informing the discussion.

Threshold RPNA Level Where Nonforfeiture Benefits Must Be Provided

The WG recognized that there may be levels of prefunding under the GPNM below which only certain nonforfeiture benefits or no nonforfeiture benefits at all need be provided. The concept of what constitutes a threshold level of prefunding for RPNA purposes is beyond the scope of this report. After discussing this issue at length, the WG decided to limit its discussion in this report to setting out the criteria it feels should guide the decision as to what any threshold level of prefunding should be. These criteria are set forth in Section V of the report.

Also, and again solely to inform the discussion of this issue, the WG decided to set out in the report (Section V) some possible suggested actuarial approaches to establishing a threshold prefunding level. The WG is not, by presenting these possible approaches in its report, recommending any one particular approach but is merely illustrating the types of approaches that satisfy the principles set forth.

The WG recognizes that the issue of the forfeiture of any amount of nonforfeiture prefunding, especially if no cash surrender value is available, has significant public policy implications.

Qualification of Life Insurance Products as Life Insurance Under IRC §7702 and §7702A and Other Tax-Related Issues

The WG received extensive information and input from the Academy’s Tax Work Group (Tax WG) on the potential effect of the GPNM proposed in this report as it relates to the requirements in §7702 of the IRC and the attendant regulations that must be satisfied by a life insurance policy in order for that policy to qualify as life insurance under the IRC. One of two tests must be satisfied to ensure a policy qualifies as life insurance: (1) the "Cash Value Accumulation Test” (CVAT), or (2) the “Guideline Premium/Cash Value Corridor test” (GP/CVC test).

Either test may be used to determine whether a policy qualifies as life insurance and therefore receives favorable tax treatment (for both the issuing company and the policyowner). With a very limited exception, the same test must be applied for the lifetime of a policy. The CVAT must be satisfied at issue and at all future durations by the terms of the contract. The GP/CVC test must be satisfied at each point in the policy's lifetime. Although either test may be used for traditional fixed premium life products or flexible premium UL type life products, traditional fixed premium life products must, as a practical matter, use the CVAT. The CVAT was designed to be used for traditional fixed premium life products (where the prescribed, guaranteed policy values make it straightforward to ensure all future values comply with the test at issue). The GP/CVC test was designed to be used with fund accumulation products like UL where NGEs make it desirable to test for the product's compliance at each future duration as values emerge and the product is flexible enough to adapt to ensure continued compliance.

Compliance with the CVAT, at issue for all future durations, is achieved by ensuring that no future cash surrender value under the policy will exceed the net single premium for the coverage provided at that point. The net single premium used for this test is to be determined based on an interest rate and mortality table set forth in §7702. The interest rate to be used is the greater of 4% and the rate or rates guaranteed upon issuance of the policy. The mortality table is the mortality table guaranteed in the policy but not to exceed the rates in the mortality table for reserves prescribed by §807(d) of the IRC (the table adopted by at least 26 states for valuation purposes) or any other mortality table adopted by Treasury by regulation. (Special provisions may apply to substandard contracts.)

It should be noted that many fund accumulation products use CVAT. When CVAT is used for a fund accumulation product, future compliance may be demonstrated at issue by including language in the policy to require future adjustments (usually to the death benefit) to ensure compliance.

There is a potential for a conflict between the cash surrender values under the proposed GPNM and the maximum cash surrender values permitted under CVAT.

The proposed GPNM is based upon the policy's gross premiums and a set of nonforfeiture assumptions for that policy. Thus, it is possible the Net Single Premium limit under the CVAT could be less than the cash surrender value under the proposed GPNM. Even if a policy complies with the CVAT limits in §7702 while on the premium paying track, there is the possibility of §7702 issues in other situations. For example, if a policy could, at any future point in time, become paid up there may be §7702 issues. Issues could also arise if the policy provides that NGEs be used to purchase additional paid up amounts of insurance based on the GPNM assumptions in the policy. The higher the gross premium for the policy, the greater this potential concern becomes. It should be noted that since CVAT must be satisfied by the terms of the contracts, the potential for these issues to arise after issue would cause a contract to fail at issue.

While the WG spent much time gaining a full understanding of the tax-related implications of the GPNM and discussed including in the body of its report some possible approaches to dealing with the issues raised, it was ultimately decided that the public policy issues involved are outside the scope of this report. The WG remains prepared to present options for resolving these issues as part of its recommended approach to nonforfeiture reform, once the issues themselves have been discussed in a broader forum. The option presented in Appendix C for fixed level premium whole life is one option for resolving this tax issue for these types of products.