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Michael W. Boerner, MAAA, ASA
Chair
Life Actuarial Task Force
National Association of Insurance Commissioners

Dear Mike,

Pursuant to your request, the American Academy of Actuaries[1] Nonforfeiture Modernization Work Group (NFMWG) has prepared a summary of the its activity to help determine the best next steps with regard to potential updates to the life and annuity National Association of Insurance Commissioners (NAIC) standard nonforfeiture laws.

The NFMWG was established by the Academy's Life Practice Council to consider the feasibility of revising the existing life insurance and annuity nonforfeiture laws and to interface with the regulators at the NAIC's Life Actuarial Task Force (LATF) on those matters. Most recently, the request made of the NFMWG by LATF states:

"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."

State nonforfeiture laws have not kept pace with associated product evolution and innovation. Product designs such as Guaranteed Minimum Withdrawal Benefits, Contingent Deferred Annuities, and Universal Life with Secondary Guarantees were not contemplated in the development of existing nonforfeiture requirements, since such products did not exist in the marketplace at that time. These prescriptive and formula-based nonforfeiture laws have become increasingly disconnected with the contract termination possibilities inherent in new life insurance and annuity product designs that have been developed since the laws were first enacted decades ago. In lieu of broader reforms, product-specific nonforfeiture requirements have been developed as needed.

[1] The American Academy of Actuaries is an 18,500+ member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

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The NFMWG's Report, *Report of the Nonforfeiture Improvement Work Group*[2] (the Report), dated August 2011, set forth in broad terms a proposed risk-based approach to the determination of nonforfeiture benefits for life insurance and annuity products, together with a set of principles that serves as its basis. This approach, the Gross Premium Nonforfeiture Method (GPNM), uses the retrospective accumulation of the premiums or charges paid for the risks assumed, less charges for the risks to the date of termination and appropriate expenses, with appropriate adjustments for interest and applicable external factors. It is important to note that, unlike current nonforfeiture requirements, the Report presents a critical distinction between a nonforfeiture benefit (a benefit that represents a continuation of the existing contract in some form) and a cash surrender value. Since the Report was submitted, the NFMWG has continued to "flesh out" the specifics of the GPNM and has provided periodic updates to LATF. These reports to LATF, while met with many intuitive and valuable comments, have not resulted in a clear and definitive direction for the NFMWG to move forward with nonforfeiture reform.

The summary below provides additional information on the key considerations affecting nonforfeiture that the NFMWG has identified.

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Introduction

The Academy's Nonforfeiture Improvement Work Group (NFIWG, later, the Nonforfeiture Modernization Work Group or NFMWG) was formed in 2003. Since then, the NFMWG has periodically reported to the NAIC's Life & Health Actuarial Task Force (LHATF, later, LATF) on various topics related to life and annuity nonforfeiture.

In August 2011, after reviewing:

- the landscape of insurance products covered by nonforfeiture requirements,
- the treatment of those products that appear not to fit well with the requirements,
- the environment for insurance products in the financial marketplace,
- the possibilities for product designs that do not exist in the current environment, but might be possible given changes to nonforfeiture requirements, and
- the principles historically underlying nonforfeiture requirements,

the NFIWG developed a general approach to nonforfeiture reform and provided a comprehensive report on its work.

Subsequent to the August 2011 report, the work group has continued to consider and report on various topics, including examples of how the general approach would apply to specific products, public policy considerations that would affect or be affected by nonforfeiture modernization, and additional details of how the general approach might be applied.

An important consideration for potential nonforfeiture reform concerns public policy issues. When the current life and annuity nonforfeiture laws were adopted (1940's and 1980's respectively), one of the underlying principles was that nonforfeiture benefits should be provided whenever material prefunding was present. Products have evolved over the many years since

[2] http://www.actuary.org/files/publications/NFIWG_Final_Report_with_cover_8-22-11.pdf

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then, and some currently popular products that have prefunding (e.g., level premium term insurance and certain living benefits on life insurance and annuity products) typically do not provide nonforfeiture benefits. A key public policy issue is whether all products with prefunding should be mandated to provide nonforfeiture benefits (which would likely drive consumer costs higher than today), or whether consumer choice to select lower-cost products without nonforfeiture benefits should be preserved.

Key Considerations Driving Potential for Nonforfeiture Reform

1. Underlying Principles (Terminating vs. Persisting Policyholders)

   Existing nonforfeiture regulations were developed with the goal of providing the largest possible nonforfeiture benefits to terminating policyholders that would not unduly affect the benefits available for persisting policyholders. Potential changes to nonforfeiture could be measured against this goal, or alternatively an updated version of it reflecting current public policy. If the existing goal continues to be applicable, it would need to be expressed in quantifiable terms for the impact of changes to be measurable.

2. Consumer Choice vs. Consumer Protection

   As outlined above, public policy decisions regarding consumer choice vs. consumer protection are a key driver of the potential direction and viability of nonforfeiture reform. Mandated nonforfeiture benefits and/or cash values are examples of consumer protection.

3. Effect on New Sales of Existing Products

   It may not be feasible to modify some existing products in order to comply with the requirements of a revised approach to nonforfeiture (whether a general approach or some other change to existing requirements). If such products need to remain available unchanged, nonforfeiture requirements for those products would need to be addressed.

4. Required Benefits (Cash Values vs. In-Kind Benefits)

   Although cash values are generally required under current nonforfeiture requirements, the NFMWG's view is that a distinction should be made between nonforfeiture requirements for cash values and those for in-kind benefits, with cash values, if available or required to be available, potentially subject to different (though related) considerations.

5. Methodology (Prescriptive Formulas vs. General Approach)

   Results of nonforfeiture determinations using prescriptive formulas are likely to be more easily derived and reviewed than under a general approach. However, a more general approach could take into account product features that were not considered when the prescriptive formulas were adopted.

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Pros and Cons of the General Approach to Nonforfeiture Reform

Potential Benefits of the General Approach

1. Broader product choices for consumers

2. Nonforfeiture benefits that better reflect inherent guarantees and prefunding

3. Enhanced regulatory oversight capability using additional filing information

4. Consistent framework across product lines and states

5. Potentially lower costs for certain products to consumer (e.g., if cash values not required)

6. Products that are easier to understand, more transparent

7. Product innovation facilitated (e.g., combination products that consumers can adapt to their changing needs)

Potential Challenges of the General Approach

1. General method is relatively simple in concept, but complex in practice

2. Potentially higher costs to consumer for certain products (e.g., if nonforfeiture benefits are added to products such as level premium term insurance that do not presently have them)

3. No current consensus among regulators, industry, agents, and consumers that nonforfeiture reform is needed

4. Major effort, rivaling the effort in developing principle-based reserves for life products, involving many stakeholders, limited resources, along with potential implementation costs (e.g., systems updates)

5. Some existing products might not meet the new requirements, and could need to be modified, exempted or withdrawn from the market

6. Setting guardrails on assumptions requires judgment

7. Federal requirements affecting insurance products that rely on nonforfeiture requirements may need alignment (e.g., those from the SEC and IRS)

8. Additional professional judgement and guidance would be required under a general approach, compared to today's prescriptive standards

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Pros and Cons of Mandated Cash Values on Products That Have In-Kind Nonforfeiture Benefits

Pros

1. Allows customer to address changing needs

2. Provides value to consumers who do not wish to use a secondary market

3. Protects less informed policyholders

4. Keeps non-guaranteed elements (NGEs) in line by providing an exit strategy for consumers

Cons

1. An incentive for product complexity, used to weaken or neutralize the requirement

2. Limits market for insurance products (e.g., where market does not need cash values)

3. Difficulty of determining equivalent cash and in-kind benefits under varying market conditions, in contrast to in-kind benefits (which, for example, do not create disintermediation risk)

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I hope you find this information helpful, and I would be happy to discuss at your convenience or please contact Amanda Darlington, life policy analyst, at darlington@actuary.org.

Sincerely,

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