

LIFE INSURANCE AND ANNUITIES (A) COMMITTEE

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Terri Vaughan, Chair—Iowa
Neil D. Levin, Vice Chair—N.Y.

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MINUTES

The Life Insurance and Annuities (A) Committee met in Salon CD of the Marriott Copley Place Hotel in Boston, Mass., at 8:30 a.m. on June 24, 1998. A quorum was present and Terri Vaughan (Iowa) chaired the meeting. The following committee members were present: Martin Carus representing Neil D. Levin, Vice Chair, (N.Y.); Lester Dunlap representing James H. Brown (La.); Cindy Martin representing Linda Ruthardt (Mass.); Jerry Fickes representing Chris P. Krahling (N.M.); Dan Keating representing John Crawford (Okla.); and Leslie Jones representing Lee P. Jedziniak (S.C.).

1. Report of Synthetic GIC Working Group

Mark Peavy (NAIC/SSO) reported for Larry Gorski (Ill.) that the working group continues to review the Synthetic Guaranteed Investment Contract Model Regulation and anticipates a conference call to consider additional issues. Jerry Fickes (N.M.) moved and Leslie Jones (S.C.) seconded a motion to receive the report of the Synthetic GIC Working Group (Attachment One). The motion passed.

2. Report of Equity-Indexed Products Working Group

Mr. Fickes reported that the working group heard a presentation on agent training for sellers of equity-indexed products. There are at least 69 equity-indexed products currently on the market and their sales were \$3.5 billion in 1997. He noted that 72% of agents making sales have National Association of Securities Dealers (NASD) Series 6 licenses. The working group discussed the best ways to implement agent training and heard that most companies are attempting some type of training program.

Mr. Fickes said the working group will get a copy of the *Market Conduct Examiners Handbook* and review the information relative to agents' training for equity-indexed products. The working group set out a work plan to accomplish its charges and reviewed the guidelines from states that have specific guidelines for equity-indexed products. Commissioner Terri Vaughan (Iowa) asked if the guidelines are included as an attachment to the minutes and Mr. Fickes responded affirmatively. Commissioner Vaughan said she was involved in revising the *Market Conduct Examiners Handbook* and noted that it was guidance to examiners to check compliance with current law. She emphasized that the current law may not adequately address the equity-indexed products issues.

Mr. Fickes moved and Dan Keating (Okla.) seconded a motion to receive the report of the Equity-Indexed Products Working Group (Attachment Two). The motion passed.

3. Report of Life Disclosure Working Group

Tom Foley (N.D.) said the Life Disclosure Working Group met in Boston on two occasions and decided to adopt an annuity disclosure regulation and updated buyer's guide for deferred annuities within four to six weeks. He said the disclosure model basically would be Sections 1 through 5 of the Annuity Disclosure and Illustrations Model Regulation draft. He said the working group made significant steps forward on supportability issues but this will take at least another six months to finalize, so the working group decided to go forward with the disclosure portion of the document.

Mr. Foley said an appendix to that disclosure regulation will be the Fixed Deferred Annuities Buyer's Guide that the working group is finalizing. He said there is a potential for a significant amount of confusion because the industry is voluntarily using the Equity-Indexed Annuities Buyer's Guide that the working group prepared as an interim measure. He said some companies may have printed many copies of this document and the working group hopes they will continue to distribute this through 1998. By the beginning of 1999, the working group expects the general Fixed Deferred Annuities Buyer's Guide to be adopted by the NAIC and anticipates companies beginning to use that document. The working group expected to make minor changes to the buyer's guide during the Summer National

Meeting, but the revisions turned out to be so extensive that they could not be completed in time. Mr. Foley said the working group anticipates completing this document in early August.

The working group heard a report about what the Securities and Exchange Commission (SEC) is doing with regard to variable life insurance. Representatives from the NAIC met with the SEC in 1994-1995 and will probably meet with them again to discuss the proposal currently distributed. The American Academy of Actuaries (AAA) gave an update about its activity on supportability. In the fall the working group expects to begin work on a review of the Life Insurance Illustrations Model Regulation. The working group heard an AAA report of a survey on life insurance illustrations and this will highlight for the working group some areas that need review.

Ms. Jones moved and Mr. Keating seconded a motion to receive the Life Disclosure Working Group report (Attachment Three). The motion passed. Commissioner Vaughan applauded the idea of postponing the discussion on illustrations so that the disclosure document will be available more quickly.

4. Report of Replacement Issues Working Group

Paul DeAngelo (N.J.) reported that in March the working group gleefully handed up to the A Committee the Life Insurance and Annuities Replacement Model Regulation; that euphoria did not last long. At a subsequent conference call of the Life Insurance and Annuities (A) Committee, the working group was asked to review five specific areas. The working group reviewed these areas and made some changes to the regulation. Mr. DeAngelo noted that the working group declined to exempt annuities from the regulation because the current NAIC model does include them, but annuities were deleted from the definition of financed purchases. The working group considered an alternative proposal for submitting sales material where the company does not allow agents to use anything other than company-approved materials. These companies are relieved from the burden of filing that material. This will address many of the concerns of the insurance industry but still allow regulators to reach their goals. Changes also were made to the section on direct response sales.

Mr. DeAngelo said the working group was hesitant to employ other than the NAIC's usual procedure of leaving the effective date for a regulation to the state. If the A Committee wants to add an effective date, the working group would recommend that a delayed effective date apply only to Section 5 where the systems requirements are contained. Commissioner Vaughan said she did not have strong feelings about putting a recommendation in the text of the model, but she requested that the minutes reflect the regulators' preference that Section 5 not be effective until at least Jan. 1, 2001. She said that Year 2000 issues are significant and could threaten the viability of business. If a company has Year 2000 problems, consumers will be harmed. Regulators should not place additional burdens on companies that are unrelated to the Year 2000 issues. Ms. Jones moved and Mr. Keating seconded a motion that Commissioner Vaughan carry to the Executive Committee a recommendation from the A Committee that Section 5 not be imposed on companies until after the Year 2000. The motion passed. Mr. DeAngelo commented that he was comfortable with this delay because other sections of the model have significant consumer protections and many companies are already dealing with the issues raised by Section 5. He noted that the requirements of Section 5 also protect companies, so many will implement them earlier than required as their systems requirements are met.

Mr. DeAngelo said the working group also discussed a charge to review advertising rules and he concluded that the most necessary changes are not in the area of replacement, but rather insurance illustration issues. He recommended that the Life Disclosure Working Group be charged with the responsibility to review the Rules Governing the Advertising of Life Insurance. An additional charge from the A Committee is to discuss suitability issues and Mr. DeAngelo noted that these are not limited to replacements. He said the members of the working group are willing to continue in existence for discussion of suitability issues. Commissioner Vaughan said that when the charges were discussed in January, this working group was identified as the appropriate place for that charge. Commissioner Vaughan noted that the A Committee may want to change the name of the working group to reflect its new charge.

Mr. Fickes moved and Ms. Jones seconded a motion to adopt the report of the Replacement Issues Working Group, including adoption of the Life Insurance and Annuities Replacement Model Regulation. The motion passed (Attachment Four).

5. Report of the Life and Health Actuarial (Technical) Task Force

Mr. Foley reported that the Life and Health Actuarial (Technical) Task Force met in Kansas City in early June. A report was received from the AAA regarding its proposal for a new system of valuation for assets and reserves. Because this valuation project is long term, the nonforfeiture project is also delayed. Mr. Foley expressed frustration with the lack of cooperation of the industry on the nonforfeiture project and said regulators had decided to put together a new draft similar to the New York guidelines. As part of the Codification project, the reinsurance questions and answers document was significantly discussed and the goal of the task force is to complete this project by the end of 1998.

A concerted effort is being made by the life insurance industry to agree on amendments to the Valuation of Life Insurance Policies Model Regulation (known as Guideline XXX) so that more states will adopt this model regulation. The regulators in attendance at the task force meeting prepared a list of 33 questions on issues related to the XXX project and the life insurance industry is responding to these questions. Scott Cipinko (National Alliance of Life Companies—NALC) said the industry is now reviewing the questions and hopes to bring a consensus document to the regulators in December. He noted that the state of Wisconsin has a Jan. 1, 1999, effective date for its regulation so there is some sense of urgency to be finished before then. Commissioner Vaughan asked Mr. Foley if that was the time frame he envisioned. Mr. Foley responded that the NAIC has already adopted this regulation, and it is up to the industry to suggest any changes that might be appropriate.

Martin Carus (N.Y.) moved and Mr. Fickes seconded a motion to receive the report of the Life and Health Actuarial (Technical) Task Force. The motion passed.

6. Report of Viatical Settlements Working Group

Lester Dunlap (La.) said the working group's charge is to review the Viatical Settlements Model Regulation and make appropriate recommendations for revisions. This project is facilitated because more than 20 states now regulate viatical settlements, giving the regulators a pool of experience from which to draw. He noted that participation from the viatical settlement industry is also helpful. A draft of proposed changes was prepared and discussed extensively at the working group meeting. A group of technical resource advisors from both the viatical settlement industry and the life insurance industry are developing procedures and forms to expedite information transfer between insurers and viatical settlement providers and brokers. This group has committed to having a draft for review at an interim meeting of the working group in Kansas City. Mr. Dunlap moved and Mr. Keating seconded a motion to receive the report of the Viatical Settlements Working Group (Attachment Five). The motion passed.

7. Adopt Minutes of May 28, 1998 Conference Call

Mr. Keating moved and Mr. Fickes seconded a motion to adopt the minutes of the May 28, 1998, conference call of the Life Insurance and Annuities (A) Committee (Attachment Six). The motion passed.

8. Discuss Charge to Oversee Production of Market Share Reports for the Top 125 Life and Fraternal Insurance Groups and Companies by State

Commissioner Vaughan noted that one of the charges of the A Committee is to oversee production of the market share report for life and fraternal companies. Natalie Webster (NAIC/SSO) explained this project and noted that the report is divided into three sections: life, annuity and total including deposit funds. The bulk of the preparation is done by the NAIC's Information Systems Division. A preliminary report will be available for review by the A Committee at the Fall National Meeting. After approval by the A Committee, the NAIC will print and distribute the report.

9. Any Other Matters Brought Before the Committee

Mr. Fickes noted that the Charitable Gift Annuities Model Act had been returned to the A Committee from the Executive Committee for further review and revisions. Commissioner Vaughan suggested reconstituting the Annuities Working Group to consider the three issues as directed by the Executive Committee: reserves, guaranty fund coverage, and a request that the A Committee consider development of an alternative model to exempt certain classes of charities.

Commissioner Vaughan noted that the Summer National Meeting is Mr. Fickes' last meeting as an insurance regulator and she read a resolution thanking him for his assistance over the past 10 years.

Having no further business, the Life Insurance and Annuities (A) Committee adjourned at 9:50 a.m.

ATTACHMENT ONE

Synthetic GIC Working Group Boston, Massachusetts June 21, 1998

The Synthetic GIC Working Group of the Life Insurance and Annuities (A) Committee met in Salon F of the Marriott Copley Place Hotel in Boston, Mass., at 4 p.m. on June 21, 1998. Larry Gorski (Ill.) chaired the meeting. The following working group members or their representatives were present: Sheldon Summers representing Woody Girion (Calif.); Allen Elstein representing Jack Gies (Conn.); Clark Simcock representing Reginald Berry (D.C.); and Paul DeAngelo representing Lynda Kiebold (N.J.).

Larry Gorski (Ill.) noted that several pieces of correspondence had been distributed to the regulators: Alastair Longley-Cook (Aetna) May 27, 1998, memo (Attachment One-A); Allen Elstein (Conn.) June 5, 1998, memo (Attachment One-B); Zahid Hussain (Transamerica) June 9, 1998, memo (Attachment One-C); Eric Keener (Aetna) June 4, 1998, memo (Attachment One-D); Cynthia Hargadon (Stable Value Investment Association) June 15, 1998, memo (Attachment One-E); Mr. Keener June 15, 1998, memo (Attachment One-F); Victor Gallo (Jackson National) June 15, 1998, memo (Attachment One-G); Michael Cioffi (Diversified Financial Products) June 15, 1998, memo (Attachment One-H); and Jeff Mohrenweiser (CNA) June 16, 1998, memo (Attachment One-I). He noted that most of the correspondence concerned points contained in the May 15, 1998, draft Synthetic Guaranteed Investment Contracts Model Regulation (Attachment One-J).

Next, Doug Barnert (Barnert & Associates), representing Transamerica and the Stable Value Investment Association, stated that several companies and organizations continue to have concerns regarding the approval process for the plan of operation applicable to non-domiciliary states.

Next, Mr. Elstein reviewed the recommendations in his June 5, 1998, memo. That memo suggested definitions for "Target Duration of Assets," "Withdrawal Hierarchy," and "Discontinuation Trigger (Action Point or Trigger Point)," as well as additional items for inclusion in the plan of operation. In summarizing his memo, Mr. Elstein stated that Connecticut "was not in the business of approving generic plans of operation." Mr. Gorski noted that Mr. Keener's June 15 memo responded to the points raised in Mr. Elstein's memo.

A review then occurred of the three definitions in Mr. Elstein's memo. Mr. Gorski recommended that the proposed definitions of "Target Duration of Assets" and "Discontinuation Trigger (Action Point or Trigger Point)" be included in the next draft. Relative to the proposed definition of "Withdrawal Hierarchy," Mr. Gorski asked if inclusion in the plan of operation of a range of withdrawal hierarchies would be an acceptable compromise between Mr. Elstein's and Mr. Keener's positions. Mr. Elstein stated that the range would probably have to be narrow in order to obtain Connecticut's approval for the plan of operation. Mr. Gorski then recommended that Mr. Elstein's proposed definition be included in the next draft.

Christina Stiver (Transamerica) stated that it will be very difficult to include a specific withdrawal hierarchy in the plan of operation, since they tend to be unique to each contract. After a brief discussion, it was agreed that further discussions will occur on an upcoming conference call to determine the precise requirements for describing withdrawal hierarchies in the plan of operation.

Next, a discussion occurred relative to Mr. Elstein's proposal to include a description of the hedging techniques to be utilized relative to contracts covered by a plan of operation. Mr. Gorski stated that he supports this proposal to assure that the hedging strategies are clearly understood by both the regulators and companies. Ms. Stiver expressed a concern that it will be difficult to adequately describe every hypothetical circumstance that will involve hedging. Mr. Gorski stated that this item (as well as the proposal on duration matching) may be another instance where the language incorporated into the plan of operation would describe a range of techniques, as opposed to a single practice.

Mr. Gorski stated that a conference call will be held either the last week of July or the first week of August to continue the discussion on the correspondence that was received. He asked that any additional comments be submitted by the third week of

July so that they could also be considered on that call. Mr. Gorski also stated that he will develop a drafting note on "Affirmatively Adopted" for the call.

The working group reviewed the minutes of the April 15, 1998, joint conference call of the Synthetic GIC Working Group and the Separate Accounts Working Group of the Accounting Practices and Procedures (EX4) Task Force (see pages 255-257 of this volume of the *NAIC Proceedings*). Sheldon Summers (Calif.) moved and Clark Simcock (D.C.) seconded that the minutes be adopted. The working group voted to adopt the minutes.

Having no further business, the Synthetic GIC Working Group adjourned at 5 p.m.

ATTACHMENT ONE-A

To: W. Blaine Shepherd, Director, Actuarial & Regulatory Policy Analysis (Minn.)
 Larry Gorski, Life Actuary (Ill.)
 From: Alastair G. Longley-Cook, VP & Corporate Actuary, Aetna
 Date: May 27, 1998
 Re: Certain Additional Provisions in the Proposed Model Regulations on Separate Accounts and Synthetic GICs

In response to the April 15 Life and Health Actuarial Task Force Joint Working Group conference call request to include provisions from the Actuarial Opinion and Memorandum Regulation related to confidentiality and reliance, the American Academy of Actuaries working groups on the subject model regulations recommend the following revisions:

I. Confidentiality

An addition to the separate accounts regulation Section 9(A) should include Standard Valuation Law (SVL) 3(D)(8) language on confidentiality as well as Actuarial Opinion and Memorandum (AO&M) regulation section 9(A)(1) on availability as follows:

Any memorandum in support of the opinion, and any other material provided by the company to the commissioner in connection therewith, shall be kept confidential by the commissioner and shall not be made public and shall not be subject to subpoena other than for the purpose of defending an action seeking damages from any person by reason of any action required by this section or by regulations promulgated hereunder; provided, however, that the memorandum or other material may otherwise be released by the commissioner (a) with the written consent of the company or (b) to the American Academy of Actuaries upon request stating that the memorandum or other material is required for the purpose of professional disciplinary proceedings and setting forth procedures satisfactory to the commissioner for preserving the confidentiality of the memorandum or other material. Once any portion of the confidential memorandum is cited by the company in its marketing or is cited before any governmental agency other than a state insurance department or is released by the company to the news media, all portions of the confidential memorandum shall be no longer confidential.

The memorandum shall be made available for examination by the commissioner upon his or her request but shall be returned to the company after such examination and shall not be considered a record of the insurance department or subject to automatic filing with the Commissioner.

Similarly, the Synthetic Guaranteed Investment Contract Regulation Section 10(B)(1) would add the word "confidential" before "memorandum" in the first sentence and add the above two paragraphs to the end of that section.

As requested by the Life and Health Actuarial Task Force Joint Working Group, each addition should end with the drafting note:

[DRAFTING NOTE: Each state should review its laws regarding confidentiality of industry provided information and conform those provisions accordingly.]

New sections 9(E) and 10(E) should be added to the Separate Accounts and Synthetic GIC regulations, respectively, with language from SVL Section 3(D)(6) on protection for the actuary, as follows:

Except in cases of fraud or willful misconduct, the qualified actuary shall not be liable for damages to any person (other than the insurance company and the commissioner) for any act, error, omission, decision or conduct with respect to the actuary's opinion.

II. Reliance

The Actuarial Opinion and Memorandum Regulation contains a specific requirement for a reliance paragraph in Section 8(A)(3) which states:

A reliance paragraph describing those areas, if any, where the appointed actuary has deferred to other experts in developing data, procedures or assumptions, (e.g., anticipate cash flows from currently

owned assets, including variation in cash flows according to economic scenarios (see Section 8B(3)), supported by a statement of each such expert in the form prescribed by Sections 8E and 8F.

The references to regulation governing content of actuarial opinion in the proposed Separate Accounts regulation Section 9(B), and Synthetic GIC regulation Section 10(B)(3), should include reference to this AOMR Section 8(A)(3).

Please let me know if we can be of any further assistance.

ATTACHMENT ONE-B

To: Mark D. Peavy (NAIC)
 From: Allen R. Elstein (Conn.)
 Date: June 5, 1998
 Re: Synthetic GIC Draft of May 15, 1998

The following comments regarding the proposed model regulations dealing with synthetic guaranteed investment contract (GIC) are directed to Messrs. Gorski (Ill.) and Shepherd (Minn.) respectively, chairs of NAIC work groups with respect to these models. The comments apply primarily to synthetic GICs but may be relevant to Mr. Shepherd's Guarantees Funded Through Insurer Separate Accounts group as well. Specifically, these comments are directed to the May 15 synthetic GIC draft. The concepts have proved useful in Connecticut approvals in the absence of a regulation.

Section 4. Definitions

V. "Target duration of assets" means the duration to which the separate account or asset portfolio is being managed. Target duration may be based on a specific future maturity year, a constant duration target based on the liability duration or some other method defined in the plan of operation.

W. "Withdrawal hierarchy" means with respect to a separate account or an asset portfolio which is a funding basis for an account contract which is one of several interrelated contracts held by the contractholder, a protocol among the funding contracts according to which withdrawal or other benefit payments are prioritized in a manner that is non-proportional among the funding contracts. For example, if a single asset portfolio corresponding to a contract with the insurer is responsible for all plan withdrawals, notwithstanding the existence of assets supporting other contracts not with the insurer (for example, LIFO treatment), a withdrawal hierarchy exists.

X. "Discontinuation trigger (action point or trigger point)" means, with respect to a separate account or an asset portfolio and its associated guaranteed contract liabilities, a threshold value of the margin between asset values and liability values, at which level the contract provides for correction action.

Section 5E(1) The Plan of operations shall include at least:

- (o) a description of the withdrawal hierarchy, if any;
- (p) if hedging instruments or dynamic hedging techniques are to be utilized in managing separate account or asset portfolio assets, a description of such instruments and techniques and an explanation of how they are intended to reduce risk of loss;
- (q) a description of the insurance company's remedies, including any unilateral contract termination remedies, in the event that the investment policy governing the asset portfolio is materially violated;
- (r) if any book value guarantees are made on the account contract or individual participant level, a description of the cash flow matching and/or duration matching, if applicable, done to assure that assets are adequate to mature the liabilities;
- (s) a statement that all unilateral contract termination events that have not been cured within the time period allowed in the account contract and where the insurance company has not terminated the contract shall be reported to the Department within 60 days;
- (t) a description of the specific independent investment managers or independent investment advisors to be used, if any, and the insurance company's criteria for approving such managers or advisors together with an undertaking to notify the Commissioner of any additions or changes in independent investment managers or independent investment advisors, the reasons, and any anticipated investment changes subsequent to plan of operation approval;
- (u) a statement that material changes in the plan of operation will be filed with the Commissioner stating the reason for such change and whether they modify the insurance company's risk assumption;
- (v) a description of the disposition (allocation) of loss for defaulted securities controlled by an independent investment manager or independent investment advisor between the insurance company, the contract owner, and the independent manager or independent investment advisor; and

(w) a description of the target duration (if any).

Section 10. Reserves

A(2)(a) For debt instruments, the percentage shall be the NAIC asset valuation reserve "reserve objective factor," but the factor shall be increased by fifty percent (50%) percent for the purpose of this calculation in the difference in durations of the assets and liabilities in more than one year six months.

Drafting note: Virtually all such accounts are matched in actuality to less than 6 months. The one year is a remnant of less sophisticated times and higher margins for error (higher profit margins).

ATTACHMENT ONE-C

To: Mark Peavy (NAIC)
 From: Zahid Hussain, VP & Associate Actuary, Transamerica Asset Management
 Date: June 9, 1998
 Re: Draft of the Synthetic Guaranteed-Investment Contract Model Regulation

The following comments are submitted on behalf of Transamerica Life Insurance and Annuity Company. We are following up on earlier comments that were submitted by us to you on Feb. 2, 1998. We appreciate the opportunity to comment on the model regulation being developed by the synthetic GIC Working Group. We would like to echo our earlier comments about this model regulation being fair and reasonable in important regulatory issues such as setting up reserves. This business involves relatively low risks and the reserving mechanisms set in place by the Working Group ensure that adequate reserves are set for any risk that might be taken.

There are several concerns that we have in the model regulation that relate mostly to the Plan of Operation filing requirements that are imposed on insurance companies. As you know, banks and other financial companies are not required to file their products with the banking regulators. By conforming to these filing requirements, insurance companies will have an enormous competitive disadvantage in costs, speed of product delivery, innovation and customer relations.

Filing the Plan of Operations: The model regulation should require the plan of operation to be filed only in the state of domicile. The requirement to file the plan of operation in each state should be rescinded. There are several observations that I would like to make:

1. Solvency is the primary responsibility of the domiciliary state. The NAIC framework places primary reliance on the state of domicile to regulate the solvency of insurance companies. Similarly, each product's financial status should not have to be approved by all 50 states. Other states have an interest in the solvency of foreign companies and therefore get information on the overall asset adequacy of these companies.
2. Filing the plan of operation piecemeal for various products in various states does not help any state in monitoring the financial solvency of a foreign insurance company since the foreign insurance company will only file a plan of operation if it is writing a given product in that state. One state will, therefore, never have complete information on any given foreign company.
3. States do not have the resources to adequately and quickly review the plan of operation filings for all separate account and synthetic products being written by all companies. It is far better to have the plan of operation reviewed only by the state of domicile (the one with the most interest in the company's solvency). This reduction in paperwork will ensure that the plan of operations that do get filed get both a timely and thorough review by the regulators.
4. Competitive pressures simply don't allow for the luxury of filing and waiting for products to get approved. Insurance companies are competing with other companies who are not subject to the same rules and can therefore produce this product quicker and cheaper. In addition, these filing requirements would seriously inhibit the insurer's ability to innovate and adapt the products to the changing market needs.
5. This proposal goes against the trend of deregulation of sophisticated markets. These contracts are generally issued through or to Qualified Pension Asset Managers and are issued in sizes of \$1 million or more. There is no consumer interest in having these products be reviewed by the insurance regulators. In addition, an NAIC white paper from a task force on deregulation of the commercial lines calls for the deregulation of comparably sophisticated products in commercial lines.

Thank you for the opportunity to submit these comments. In one of the earlier meetings on this subject, the Working Group Chair Reginald Berry (D.C.) had indicated his desire to develop a model regulation that will "assist the industry to safely compete" with others that are selling products similar to synthetics GICs. We believe that the insurance regulations should attempt to make the playing field as level as possible for all players in the marketplace. Removing the possibility of having to file the plan of operation in each state would help tremendously in achieving that. Please let me know if I can be of any assistance.

Suggested Changes to Section 5 of the Synthetic GIC Model Regulation

Amend Subsection 5(C) of the Draft NAIC Synthetic Guaranteed Investment Contract Model Regulation (5/15/98) as follows:

C. A non-domestic insurer will satisfy the filing and approval requirements of this section if the insurer has filed a form of the contract with the commissioner, and such form of the contract has been affirmatively approved or has not been disapproved within the sixty (60) day period following receipt by the Department of such filing, in which event such form of contract shall be deemed approved.

The above has been amended from the current following script as follows:

C. A non-domestic insurer will satisfy the filing and approval requirements of this section if the insurer has filed a form of the contract ~~together with a copy of the plan of operation pertaining to the contract~~ with the commissioner, and such form ~~and such plan of operation have of the contract has~~ been affirmatively approved or ~~have~~ has not been disapproved within the sixty (60) day period following receipt by the Department of such filing, in which event such form of contract ~~and such plan of operation~~ shall be deemed approved. ~~Notwithstanding the forgoing, the requirement for filing and approval of the plan of operation shall be waived.~~

~~(1) Upon expiration of the thirty (30) day period following receipt by the Department without return comment of notice by the insurer that the insurer's domiciliary insurance department has promulgated rules or regulations governing synthetic guaranteed investment contracts that are substantially similar to this regulation, and that the domiciliary insurance department has affirmatively approved such plan of operation. Evidence of affirmative approval and reference to such rule or regulation shall be included with the notice; or~~

~~(2) At the discretion of the commissioner.~~

ATTACHMENT ONE-D

To: Mark Peavy (NAIC)
 From: Eric a. Keener, ASA, MAAA, Actuarial Associate, Aetna Retirement Services
 Date: June 4, 1998
 Re: Comments on the NAIC Synthetic Guaranteed Investment Contracts Model Regulation Draft

I have reviewed the most recent draft of the NAIC Synthetic Guaranteed Investment Contracts Model Regulation, dated May 15, 1998. On the whole, I believe the current draft achieves the goals of both the Synthetic GIC Working Group and the industry technical advisors. I would like to submit several minor comments, many of which are grammatical or typographical in nature:

Section 3. Scope and Application

The reference to Section 4C should be changed to Section 4, the definition of "synthetic guaranteed investment contract." Also, the phrases "fixed rate of return" in the first sentence and "fixed rates of return" in the second sentence could be changed to "fixed rate or rates of return," as there may be more than one rate of return over the life of the contract if the rate is reset by means of a crediting rate formula.

Section 4H. Definition of fair market value

In the second sentence, changing the phrase "if no price is available" to the phrase "if no such price is available" would clarify that it is the trading price of the security which is unavailable.

Section 4I. Definition of guaranteed minimum benefits

The word "either" on the second line could be removed, as it implies only two parts to the definition when there are actually three. The word "or" should then be inserted after the semicolon in the first part of the definition. Also, in the third part of the definition, the phrase "of the assets" could be stricken to clarify that it is the fair market value of the segregated portfolio that determines the contractholder's benefits.

Section 4L. Definition of investment manager

Changing the word "person" to the phrase "person or persons" would clarify the fact that there may be more than one investment manager. Also, changing the parenthetical phrase "including the contractholder" to the phrase "possibly including the contractholder" would clarify the fact that the contractholder may or may not be acting as the investment manager.

Drafting Note, page 4

Changing the phrase "it would not wish to do so" to the phrase "they would not wish to do so" would clarify that it is the regulators who might not wish a certain entity to act as a custodial institution.

Section 5E(1)(a)

The period at the end of the section should be replaced with a semicolon.

Section 5E(1)(e)

In the fourth line, the word "investment" should not be capitalized.

Section 7C

The reference to Section 5E(1)(j) should be changed to 5E(1)(k), the discussion of the investment parameters in the plan of operation.

Section 10A(2)(a)

The word "percent" following the parenthetical "50%" should be stricken.

Section 10A(4)(a)(ii)

The phrase "such a" should be inserted between "instrumentality of" and "jurisdiction."

Section 10A(6)

At the bottom of page 12, the word "than" should be inserted between "no more" and "eighty percent."

Section 10B(6)(a)

The word "payment" should be replaced with the word "payments."

Section 10B(7)(a)(ii)

The colon at the end of the section should be replaced with a semicolon.

Section 10B(7)(c)

See the previous comment.

Section 10B(7)(i)

The word "and" at the end of the section should be stricken.

Section 10B(7)(j)

A semicolon should be inserted at the end of the section.

Section 10B(7)(k)

The phrase "segregated asset portfolio" should be replaced with the phrase "segregated portfolio assets," the period at the end of the section should be replaced with a semicolon, and the word "and" should be inserted following the semicolon.

Thank you for the opportunity to provide comments on this most recent draft of the model regulation; please feel free to give me a call if you would like to discuss further.

ATTACHMENT ONE-E

To: Mark Peavy (NAIC)
 From: Cynthia Hargadon, President, Stable Value Investment Association
 Date: June 15, 1998
 Re: NAIC Model Regulation on Synthetic Guaranteed Investment Contracts

I am writing on behalf of the Stable Value Investment Association to augment comments previously submitted by the Association on Feb. 23, 1998, on the above captioned model regulation. The Association was established in 1990 to advance public awareness about stable value products, to address issues affecting these products, and to educate the public about the best ways to plan for retirement. Its members include product and service providers, such as banks and insurance companies that sell and manage stable value products, plan sponsors, investment managers and consultants.

There are several concerns that we continue to have in the model regulation which relate mostly to the Plan of Operation filing requirements that are imposed on insurance companies. We believe that the model regulation should require the Plan of Operation to be filed only in the state of domicile. The reasons for our view are as follows:

1. Extending these filing requirements beyond an insurer's domiciliary state will likely increase product costs, while slowing new product innovation and delivery.
2. States have varying amounts of available resources to review the Plan of Operation filings for all separate account and synthetic products being written by all companies. It is far better that the Plan of Operation be reviewed only by the state of domicile. This management of paperwork will ensure that the Plan of Operation filed receives a quick yet thorough review by the regulator.
3. The approach taken under the draft regulation goes against the trend of deregulation of sophisticated markets. These contracts are generally bought by Qualified Pension Asset Managers and are issued in amounts of \$1 million or more. There is no consumer interest satisfied in having the Plan of Operation for these products reviewed by each insurance regulator. In addition, an NAIC white paper produced by the Regulatory Re-engineering White Paper Working Group calls for deregulation of comparably sophisticated products in commercial lines.

We would like to point out that, while a number of our members are insurance companies, we are not an insurance company association. Our comments are made with the interest of the stable value industry in mind. In promoting effective and efficient regulatory oversight, buyers will enjoy the fruits of product innovation, sellers will be more competitive and the industry stands to be more viable overall. Not insignificantly, these benefits filter down to create better value for the ultimate beneficiaries, plan participants.

We again appreciate the opportunity to submit comments. The Association is willing to discuss our view with the working group in greater detail and in the appropriate forum.

ATTACHMENT ONE-F

To: Larry Gorski (Ill.)
Blaine Shepherd, Minn. Department of Commerce
From: Eric A. Keener, ASA, MAAA, Actuarial Associate, Aetna Retirement Services
Date: June 15, 1998
Re: Proposed Changes to May 15, 1998, Draft of the NAIC Synthetic Guaranteed Investment Contracts Model Regulation

On behalf of several of the NAIC Synthetic GIC Working Group interested parties, I would like to respond to the proposed changes to the May 15, 1998, draft of the NAIC Synthetic Guaranteed Investment Contracts Model Regulation that have been outlined by Allen Elstein of the Connecticut Insurance Department. My comments on the proposed changes are as follows:

- 1) Mr. Elstein has indicated that his comments apply to the May 15, 1998, draft of the Synthetic GIC Model Regulation, and that his comments may be relevant to the separate accounts model regulation as well. If the comments are viewed in the context of the synthetic GIC regulation, the term "separate account" should not appear.
- 2) Since "duration" is already a defined term, there is no need to add a separate definition of target duration.
- 3) Withdrawal hierarchies may be negotiated separately with each individual contractholder, and should be considered an insurer underwriting issue rather than a subject for the model regulation. Therefore, the definition of withdrawal hierarchy and the proposed addition of 5E(l)(o) should not be included.
- 4) As the term "discontinuation trigger" is not used anywhere in the model regulation, there is no need for it to be added as a defined term;
- 5) The proposed addition of 5E(1)(p) is unnecessary, as the investment guidelines already include a description of how derivative instruments may be used.
- 6) The proposed addition of 5E(1)(q) is unnecessary, as contract safeguards are already addressed in the existing Section 5E(1)(i).
- 7) The proposed addition of 5E(1)(r) is unnecessary, as the portfolio's provision for the liabilities is already addressed in the existing Section 5E(1)(f).
- 8) Uncured termination events where the insurer does not terminate the contract are already reported in the actuarial opinion and memorandum. Therefore, the proposed addition of 5E(1)(s) is unnecessary.
- 9) The existing 5E(1)(1) already discusses the criteria used in approving the investment manager. Also, the proposed 5E(1)(t)'s requirement that specific investment managers be listed is excessively onerous, as a new filing and approval would be required whenever a new manager is added.
- 10) Under the existing 5E(1)(a), the insurer must state that the contract will be administered in accordance with the plan of operation that has been filed with the commissioner. If the plan of operation changes, then it must be refiled, so the proposed addition of 5E(1)(u) is unnecessary.
- 11) The allocation of loss for defaulted securities would be covered by the descriptions of how the contract value and fair market value are determined. Therefore, the proposed addition of 5E(1)(v) is unnecessary.
- 12) The duration of the portfolio is already addressed in the investment guidelines under the existing 5E(1)(k). Therefore, the proposed addition of 5E(1)(w) is unnecessary.
- 13) The drafting note with its reference to higher profit margins is inappropriate. The model regulation should not seek to regulate insurer profitability.

Of the issues above, I am most concerned about (9) and (13), as they make reference to insurer profit margins, and could also delay the filing and approval process for synthetic GICs issued by insurers. As indicated in the existing Section 2B, one of the stated purposes of the model regulation is to aid in timely approval due to the competitive nature of the market for these products.

Thank you for the opportunity to provide these comments; please feel free to give me a call if you would like to discuss further.

ATTACHMENT ONE-G

To: Mark Peavy (NAIC)
 From: Victor A. Gallo, FSA, CFA, Vice President, Jackson National Life Insurance Company
 Date: June 15, 1998
 Re: Draft of the Synthetic GIC Model Regulation

I respectfully submit comments on behalf of Jackson National Life Insurance Company (JNL). JNL entered the group pension market in late 1995, selling guaranteed investment contracts (GICs), synthetic GICs, and funding agreements. We currently have a book of synthetic GICs totaling about \$750 million.

In general, we believe the model regulation is well conceived, particularly in the area of reserving. A considered reserving methodology will help to ensure that the risks of the business are carefully evaluated. While there are a number of minor items where we would suggest potential changes, we limit our comments to two areas which we find to be particularly troublesome for life insurance companies competing in this market:

1. Plan of Operations Filings: While the model regulation permits states to accept a copy of the plan of operations that has been approved by the insurer's state of domicile, it also provides that each state may require its own filing. In our view this may lead to an impractical and potentially unworkable situation for issuers.

By its very nature, the plan describes all the essential operating, administrative, and underwriting procedures that are to be used in offering and maintaining the product. Separate procedures for each state cannot be implemented if the product is to be run efficiently. The state of domicile ought to be relied upon to evaluate the solvency and operations of the company. If this view is not shared by non-domestic states, then a developing patchwork of reserve methodologies and operational procedures that must be followed by a product issuer could lead, over time, to an inefficient and fractured industry ill prepared to compete. To help avoid this problem, the regulation language ought to reflect a presumption that domiciliary state review of the Plan is acceptable.

2. Actuarial Opinion: We believe the model regulation should specify that synthetic GICs are to be included in the company's overall actuarial opinion on the adequacy of reserves. As it stands, the model regulation (via the language itself as well as the drafting note) implies that a separate opinion is required for synthetic GICs on a stand-alone basis. Requiring a separate opinion for every product an insurer writes would be an onerous burden. Moreover, it would not reflect the benefits of combining products and diversifying risk at the company level.

We appreciate the opportunity to provide these comments. Please feel free to call for any clarification or assistance.

ATTACHMENT ONE-H

To: Mark Peavy (NAIC)
 From: Michael A. Cioffi, Valuation Actuary, Diversified Financial Products, Inc.
 Date: June 15, 1998
 Re: Draft of the Synthetic GIC Model Regulation

On Jan. 30, 1998, I submitted comments on behalf of Diversified Financial Products with respect to the draft of the Synthetic GIC Model Regulation. We appreciate the opportunity to comment again on the model regulation and would like to restate some of our concerns with respect to the model regulation.

The most important area of concern involves the potential filing and approval of a Plan of Operations in each state. A Plan of Operations provides information which explains how an insurance company manages its operations with respect to a particular product. It is unnecessary and very costly to require a company to submit for approval in each state how it will manage its products, administrative operations, internal controls, underwriting and contractual provisions. There is also no clear manner of resolving conflicts if individual states disagree on the manner in which a company manages the items required in the Plan of Operations.

The updating of the Plan of Operations in the future may also require numerous changes each year since items related to investment parameters, benefit responsiveness, crediting rate formulas, and discontinuance provisions are often slightly changed over time in order to fit the design of a pension plan and its investment objectives. It is not practical for an insurance company to prepare, and for each state to review and approve expeditiously, minor changes to a Plan of Operations.

We believe that the regulation should state that a Plan of Operations approval by the domiciliary state is sufficient for a foreign insurer. A Plan of Operations approved by the domestic state along with the required contract provisions, the reserve requirements, and reporting requirement in the model regulation will provide in total an extremely high level of regulatory oversight.

We also believe that the model regulation should state that synthetic GICs must be included in the company's overall actuarial opinion and memorandum on the adequacy of reserves. The purpose of the actuarial opinion is to assess the adequacy of the reserves of an insurance company's liabilities. The valuation actuary should be required to opine on the adequacy of all of a company's liabilities whether they are on or off balance sheet liabilities. The specific accounting treatment of a liability should not in itself require a different opinion.

In summary, we believe that the synthetic GIC model regulation must permit underwriting flexibility in features and design in addition to providing the state insurance department regulators with sufficient comfort that the product is sound. If minor changes to a standard contract or investment parameter need to be made for a particular request for proposal, a refiling of a Plan of Operations to each state is not a practical way to get this accomplished. The Plan of Operations must be permitted to be broad enough to handle case by case differences and future updates should not require an expensive and very long process involving every state in the updating process.

Removing the requirement of filing the Plan of Operations in each state and including the synthetic GIC liabilities in the existing actuarial opinion and memorandums will reduce the burden on insurance companies. Meanwhile, the remaining items included in the model regulation will provide the insurance department regulators with a review and reporting process which is extremely adequate given the level risk inherent in a synthetic GIC product.

Thank you for the opportunity to present our comments.

ATTACHMENT ONE-I

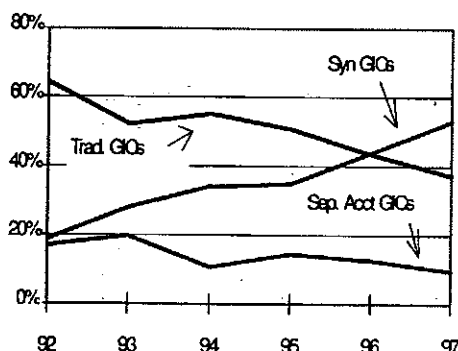
To: Mark Peavy (NAIC)
 From: Jeffrey A. Mohrenweiser, Assistant Vice President, CNA Pensions
 Date: June 16, 1998
 Re: Provisions to the NAIC Synthetic Guaranteed Investment Contracts Model Regulation

We believe the NAIC Synthetic Guaranteed Investment Contracts Model Regulation is a step in the right direction for providing a framework with which insurance departments can understand and monitor synthetic GIC products. We feel the reserving requirements are fair given the risk levels present in this product. However, certain provisions in the regulation could severely hinder insurance carriers from providing this product. The expense in terms of both time and money, of meeting these extra filing requirements, could effectively push carriers out of the synthetic marketplace. The two provisions are:

1. The filing of the Plan of Operations in multiple states, and
2. Separate actuarial opinion for this particular line of business.

Briefly, I would like to share the importance of synthetic GICs to the defined contribution marketplace. According to the Stable Value Investment Association (SVIA) and Life Insurance Marketing and Research Association (LIMRA), the product breakdown in the Stable Value option, over the past three years, has been (in millions):

| | 1995 | 1996 | 1997 |
|-----------------------|----------|----------|----------|
| Traditional GICs | 22,727.8 | 16,113.1 | 15,268.6 |
| Insurance Carriers | 22,123.8 | 15,629.3 | 15,268.6 |
| Banks | 604.0 | 483.8 | - |
| Separate Account GICs | 6,442.0 | 4,669.9 | 3,809.3 |
| Synthetic GICs | 15,625.7 | 16,331.9 | 21,814.8 |
| Insurance Carriers | 2,960.7 | 4,315.4 | 8,784.6 |
| Banks | 12,665.0 | 12,016.5 | 13,030.2 |



In 1997, one carrier converted more than \$2.5 billion of separate account GICs to synthetic GICs.

We believe the two trends to note are:

- 1) Synthetic GICs have established themselves as a viable product
 - Having grown to \$20 billion of annual sales in less than seven years,
 - Outpacing Traditional and Separate Account GICs in new sales.
- 2) Banks have established a strong presence in this marketplace
 - Nearly 60% of all Synthetic GIC placements are placed with banks (closer to 70% if the large separate account to synthetic GIC conversion is ignored).

These trends highlight the need for insurance companies and regulators to be expedient and efficient in their development and review of synthetic products. At this point, including the recent comments submitted by the State of Connecticut Insurance Department, there are as many as 23 filing requirements for the Plan of Operations. All of these requirements have the potential to be scrutinized by each state. This process can only increase the time and expense of reviews by both the insurance companies and regulators.

As other commentators to this Model Regulation have noted in previous letters, we also believe having to file the Plan of Operations in non-domiciliary states places an undue burden on insurance companies relative to our competitors. Our customers demand quick and innovative solutions which the banks are able to provide. We believe having multiple state reviews will not speed up this process; and in fact, the process can be slowed even further if certain states do not adopt the Model Regulation. Consequently, the Plan of Operations should be filed and approved in the domiciliary state with contract approvals being the responsibility of both the home state and issue state.

We also believe synthetic GICs are less risky than other insurance products. To date, the client typically assumes the investment risk through the rate reset formula, assumes the asset default risk, assumes the prepayment or extension risk, and shares in the benefit responsive risk. Although some of these risks may eventually shift back to the synthetic GIC provider (such that it mirrors a traditional GIC), there are substantial increases to capital and reserve requirements which will drive up the fees charged. To that extent, we agree that the Model Regulation has adequately addressed the risks and capital requirements for this product and a separate actuarial opinion is not needed.

We appreciate the opportunity to submit these comments. We hope that the committee re-examines the changing competitive landscape that insurers face and the potential low risk levels inherent in this product and eliminates the Plan of Operations requirements and additional Actuarial Opinion needs. Please contact me if I can be of further assistance.

ATTACHMENT ONE-J

Synthetic Guaranteed Investment Contracts Model Regulation Draft: May 15, 1998

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Section 1. Authority

This rule is issued pursuant to the authority vested in the commissioner of the State of [insert state] under [insert citation for authority].

Section 2. Purpose

A. The purpose of this regulation is to prescribe:

- (1) The terms and conditions under which life insurance companies may issue group annuity contracts and other agreements that in whole or in part establish the insurer's obligation by reference to a segregated portfolio of assets that is not owned by the insurer;

- (2) The essential operational features of the segregated portfolio of assets; and
- (3) The reserve requirements for these group annuity contracts and agreements.

B. This regulation is intended to aid in the timely approval of such products by the commissioner, and recognizes that timely approval is essential given the competitive nature of the market for these products.

Section 3. Scope and Application

This regulation applies to that portion of a group annuity contract or other agreement described in Section 4C and issued by a life insurer that functions as an accounting record for an accumulation fund and has benefit guarantees relating to a principal amount and levels of interest at a fixed rate of return specified in advance. The fixed rates of return will be constant over the applicable rate periods, and may reflect prior and current market conditions with respect to the segregated portfolio but may not reference future changes in market conditions. It applies to all contracts issued after the effective date of this regulation. Contracts that have been negotiated prior to the effective date need not be refiled with the commissioner.

Drafting Note: This explanation of the fixed rate of return is intended to clarify the fact that the regulation excludes products such as those that guarantee the future performance of a stated index. It is recognized that versions of synthetics other than those described in the scope section may evolve over time; the intent of the regulation is not to preclude the issuance of such products, but rather to describe how a specific set of synthetics (those described in the scope) should be regulated.

Drafting Note: It is expected that individual regulators, where applicable, will retain the right to withdraw approval of previously filed contract forms for new issuance if they do not conform to the regulation. Therefore, no language explicitly withdrawing approval of previously filed forms was included.

Section 4. Definitions

As used in this regulation, the following terms shall have these meanings:

- A. "Account assets" means the assets in the segregated portfolio plus any assets held in the general account or a separate account to meet the asset maintenance requirements.
- B. "Actuarial opinion and memorandum" means the opinion and memorandum of a qualified actuary required to be submitted to the commissioner pursuant to Section 10B of this regulation.
- C. "Asset maintenance requirement" means the requirement to maintain assets to fund contract benefits in accordance with Section 10 of this regulation.
- D. "Synthetic guaranteed investment contract" or "contract" means a group annuity contract or other agreement that in whole or in part establishes the insurer's obligations by reference to a segregated portfolio of assets that is not owned by the insurer.
- E. "Contract value record" means an accounting record, provided by the contract in relation to a segregated portfolio of assets, that is credited with a fixed rate of return over regular periods, and that is used to measure the extent of the insurer's obligation to the contractholder. The fixed rate of return credited to the contract value record is determined by means of a crediting rate formula or declared at the inception of the contract and valid for the entire term of the contract.
- F. "Crediting rate formula" means a mathematical formula used to calculate the fixed rate of return credited to the contract value record during any rate period and based in part upon the difference between the contract value record and the market value record amortized over an appropriate period. The fixed rate of return calculated by means of this formula may reflect prior and current market conditions with respect to the segregated portfolio, but may not reference future changes in market conditions.
- G. "Duration" means, with respect to the segregated portfolio assets or guaranteed contract liabilities, a measure of price sensitivity to changes in interest rates, such as the Macaulay duration or option-adjusted duration.
- H. "Fair market value" means a reasonable estimate of the amount that a knowledgeable buyer of an asset would be willing to pay, and a knowledgeable seller of an asset would be willing to accept, for the asset without duress in an arm's length transaction. In the case of a publicly traded security, the fair market value is the price at which the security is traded or, if no price is available, a price that appropriately reflects the latest bid and asked prices for the security. In the case of a debt instrument that is not publicly traded, the fair market value is the discounted present value of the asset calculated at a reasonable discount rate. For all other non-publicly traded assets, fair market value will be determined in accordance with valuation practices customarily used within the financial industry.
- I. "Guaranteed minimum benefits" means contract benefits on a specified date that may be either:
 - (1) A principal guarantee, with or without a fixed minimum interest rate guarantee, related to the segregated portfolio;
 - (2) An assurance as to the future investment return or performance of the segregated portfolio; or

(3) The fair market value of the segregated portfolio, to the extent that the fair market value of the assets determines the contractholder's benefits.

J. (1) "Hedging instrument" means:

(a) An interest rate futures agreement or foreign currency futures agreement, an option to purchase or sell an interest rate futures agreement or foreign currency futures agreement, or any option to purchase or sell a security or foreign currency, used in a bona fide hedging transaction; or

(b) A financial agreement or arrangement entered into with a broker, dealer or bank, qualified under applicable federal and state securities or banking law and regulation, in connection with investment in one or more securities in order to reduce the risk of changes in market valuation or to create a synthetic investment that, when added to the portfolio, reduces the risk of changes in market valuation.

(2) An instrument shall not be considered a hedging instrument or a part of a bona fide hedging transaction if it is purchased in conjunction with another instrument where the effect of the combined transaction is an increase in the portfolio's exposure to market risk.

K. "Investment guidelines" means a set of written guidelines, established in advance by the person with investment authority over the segregated portfolio, to be followed by the investment manager. The guidelines shall include a description of:

- (1) The segregated portfolio's investment objectives and limitations;
- (2) The investment manager's degree of discretion;
- (3) The duration, asset class, quality, diversification, and other requirements of the segregated portfolio; and
- (4) The manner in which derivative instruments may be used, if at all, in the segregated portfolio.

L. "Investment manager" means the person (including the contractholder) responsible for managing the assets in the segregated portfolio in accordance with the investment guidelines in a fiduciary capacity to the owner of the assets.

M. "Market value record" means an accounting record provided by the contract to reflect the fair market value of the segregated portfolio.

N. "Permitted custodial institution" means a bank, trust company or other licensed fiduciary services provider.

Drafting Note: When adopting this regulation, individual regulators may wish to review their applicable state laws to ensure that this definition hasn't inadvertently authorized an entity to act as a custodial institution that it would not wish to do so.

O. "Plan of operation" means the plan of operation filed with the commissioner of the domiciliary state pursuant to Section 5 of this regulation.

P. "Qualified actuary" means an individual who meets the qualification standards set forth in [insert statutory reference].

Q. "Rate period" means the period of time during which the fixed rate of return credited to the contract value record is applicable between crediting rate formula adjustments.

R. "Segregated portfolio" means:

(1) A portfolio or sub-portfolio of assets to which the contract pertains that is held in a custody or trust account by the permitted custodial institution and identified on the records of the permitted custodial institution as special custody assets held for the exclusive benefit of the retirement plans or other entities on whose behalf the contractholder holds the contract; and

(2) Any related cash or currency received by the permitted custodial institution for the account of the contractholder and held in a deposit account for the exclusive benefit of the retirement plans or other entities on whose behalf the contractholder holds the contract.

S. "Spot rate" corresponding to a given time of benefit payment means the yield on a zero-coupon non-callable and non-prepayable United States government obligation maturing at that time, or the zero-coupon yield implied by the price of a representative sampling of coupon-bearing non-callable and non-prepayable United States government obligations in accordance with a formula set forth in the plan of operation. To the extent that guaranteed contract liabilities are denominated in the currency of a foreign country rated in one of the two (2) highest rating categories by an independent nationally recognized United States rating agency acceptable to the commissioner and are supported by investments denominated in the currency of the foreign country, the spot rate may be determined by reference to substantially similar obligations of the government of the foreign country. For liabilities other than those described above, the spot rate shall be determined on a basis mutually agreed upon by the insurer and the commissioner.

T. "Unilateral contract termination event" means an event allowing the insurer to unilaterally and immediately terminate the contract, without future liability or obligation to the contractholder.

U. "United States government obligation" means a direct obligation issued, assumed, guaranteed or insured by the United States of America or by an agency or instrumentality of the United States government.

Section 5. Financial Qualification of Insurer; Synthetic Guaranteed Investment Contract Filing and Approval Requirements

A contract may not be delivered or issued for delivery in this state unless the issuing insurer is licensed as a life insurance company in this state and has satisfied the financial qualification requirements and the filing and approval requirements of this section. A domestic insurer may not deliver or issue for delivery a contract outside of this state unless the insurer has satisfied the financial qualification requirements of this section and satisfied the requirements of Subsection B.

Drafting Note: While the filing approach established in this regulation should over time improve the filing process in many states, it was not intended to eliminate variable filings. Although filings with appropriately limited variability may be useful to an insurer, it is expected that individual regulators will retain the authority to reject filings that request overly broad variability with respect to material contract provisions.

A. An insurer will be financially qualified under this section if its most recent statutory financial statements reflect at least ~~\$0 billion~~ \$1 billion in admitted assets or \$100 million in capital and surplus, and its risk-based capital results do not place it at a regulatory level of action. In lieu of the requirements in the preceding sentence, the insurer may be required to satisfy such other financial qualification requirements as set forth by the commissioner deemed necessary or appropriate in a particular case to protect the insurer's policyholders and the public.

B. A domestic insurer ~~satisfies will satisfy~~ the filing and approval requirements of this section if the insurer has filed a plan of operation pertaining to the contract, together with a copy of the form of the contract, with the commissioner and the filing has been affirmatively approved or has not been disapproved within ~~the sixty (60) days~~ the sixty (60) day period following ~~receipt by the Department of the such~~ filing, in which event ~~the such~~ plan of operation and ~~the such~~ form of contract shall be deemed approved.

C. A non-domestic insurer ~~satisfies will satisfy~~ the filing and approval requirements of this section if the insurer has filed a form of the contract together with a copy of the plan of operation pertaining to the contract with the commissioner, and ~~the such~~ form and ~~the such~~ plan of operation have been affirmatively approved or have not been disapproved within ~~the sixty (60) days~~ the sixty (60) day period following ~~receipt by the Department of the such~~ filing, in which event ~~the such~~ form of contract and ~~the such~~ plan of operation shall be deemed approved. Notwithstanding the foregoing, the requirement for filing and approval of the plan of operation shall be waived:

(1) Upon expiration of the thirty (30) day period following receipt by the Department without return comment of notice by the insurer in the event that the insurer's domiciliary insurance department has promulgated rules or regulations governing synthetic guaranteed investment contracts that are substantially similar to this regulation, and that the domiciliary insurance department has affirmatively approved the such plan of operation. Evidence of affirmative approval and reference to such rule or regulation shall be included in the submission with the notice; or

(2) At the discretion of the commissioner if, in his opinion, the filing and approval is not necessary for the protection of the public.

D. A contract subject to this regulation may not be written unless the assets to which it pertains and for which a contract value record is established are maintained in a segregated portfolio of a permitted custodial institution.

E. (1) The plan of operation shall include at least:

(a) A statement that the plan of operation will be administered in accordance with the requirements prescribed by the commissioner pursuant to this regulation, along with a statement that the insurer will comply with the plan of operation in its administration of the contract.

(b) A description of how the contract value record will be determined, and, where applicable, adjusted by a crediting rate formula;

(c) A statement describing the methods and procedures used to value statutory liabilities for purposes of Section 10;

(d) A description of how the fair market value will be determined, including a description of the rules for valuing securities and other assets that are not publicly traded;

(e) A description of how information concerning the assets in the segregated portfolio and related transactions will be reported to and verified by the insurer for purposes of verifying that the segregated portfolio is being managed in accordance with the Investment guidelines. The report shall be prepared no less frequently than quarterly, and shall include a complete statement of segregated portfolio holdings and their fair market value;

- (f) A description of how the investments in the segregated portfolio reflect provision for benefits insured by the contract, including any advances made by the insurer to the contractholder;
 - (g) A description of the crediting rate formula, if any, and how it will operate to take into account differences between the market value record and the contract value record over time;
 - (h) A demonstration of financial results showing at a minimum the projected contract value records, the applicable fixed rate or rates of return, the projected market value records, and how these values and rates of return may be affected by changes in the investment returns of the segregated portfolio and reasonably anticipated deposits to and withdrawals from the segregated portfolio by the contractholder, as well as any advances made by the insurer to the contractholder. The demonstration shall include at least three (3) hypothetical return scenarios (level, increasing and decreasing) and for each of these scenarios, at least three (3) withdrawal scenarios (zero, moderate and high) shall be modeled. The commissioner may require additional scenarios if deemed necessary to fully understand the risks under the contract. The demonstration period shall be the greater of five (5) years or the minimum period the insurer must underwrite the risk;
 - (i) A description of all termination events, discontinuation triggers and options, notice requirements, corrective action procedures and all other contract safeguards, including a list of events that give the insurer the right to terminate the contract immediately;
 - (j) A description of the procedures to be followed when a unilateral contract termination event occurs;
 - (k) A description of the allowable investment parameters applicable to a contract issued subject to the submitted plan of operation (such as the objectives, asset classes, quality, duration and diversification requirements applied to the assets held within the segregated portfolio), and a description of the procedures that will be followed by the insurer in evaluating the appropriateness of any specific investment guidelines submitted by the contractholder. If the insurer chooses to operate the contract in accordance with investment guidelines not meeting the criteria established in this subparagraph, approval of each non-conforming set of investment guidelines shall be obtained pursuant to Subsection B and C of this section as appropriate;
 - (l) A description of the criteria used by the insurer in approving the investment manager, if the investment manager is an entity other than the insurer, or its wholly-owned subsidiary;
 - (m) ~~A statement certified~~ An unqualified opinion by an actuary with expertise in such matters as to the adequacy of the consideration charged by the insurer for the risks it has assumed with respect to synthetic guaranteed investment contracts;
 - (n) A statement that the actuarial opinion and memorandum required by Section 10 shall include:
 - (i) If a payment has been made by the insurer under a contract in the prior calendar year, the amount of aggregate risk charges (net of administrative expenses) for synthetic guaranteed investment contracts, and the aggregate amount of any losses incurred; and
 - (ii) An inventory of all material unilateral contract termination events that have not been cured within the time period specified and that have occurred during the preceding year but where the company decided not to terminate the contract.
- (2) Review of the plan of operation by the commissioner may necessitate requests for information to supplement that furnished in the replies to the above questions. Replies made in compliance with this subsection should contain sufficient detail that any follow-up correspondence can be held to a minimum.

Section 6. Required Contract Provisions

- A. The contract shall clearly identify all circumstances under which insurer payments or advances to the contractholder are to be made.
- B. The types of withdrawals made on a market value basis shall be clearly identified in the contract.
- C. For contracts that do not have a fixed maturity schedule, the contract shall provide a settlement option permitting the contractholder to receive the contract value record over time, provided that no unilateral contract termination event has occurred.
- D. The contract shall state the maximum rate period between crediting rate formula recalculations that will be permitted, if any.
- E. The contract shall grant the insurer the right to perform audits and inspections of assets held in the segregated portfolio from time to time upon reasonable notice to the permitted custodial institution.
- F. The contract shall provide the insurer with prior notice of and the right to approve any change of investment managers.

- G. The contract shall include a waiver provision stating, or substantially similar to, the following:

No waiver of remedies by the insurer that is a party to this agreement, following the breach of any contractual provision of the agreement or of the investment guidelines applicable to it, or failure to enforce the provisions or guidelines, which constitutes grounds for termination of this agreement for cause by the insurer, and is not cured within thirty (30) days following the insurer's discovery of it, shall be effective against an insurance commissioner in any future rehabilitation or insolvency proceedings against the insurer unless approved in advance in writing by the commissioner.

- H. The insurer shall have the right to refuse to recognize any new deposits to the segregated portfolio unless there is a written agreement between the insurer and the contractholder as to the permissible levels and timing of new deposits.

Drafting Note: An adopting state may wish to add an "entire contract" provision in this section if such a provision is not required elsewhere in the adopting state's insurance code.

Section 7. Investment Management of the Segregated Portfolio

- A. The investment manager must have full responsibility for, and control over, the management of all segregated portfolio assets within the constraints specified in the investment guidelines.

Drafting Note: In the event that the segregated portfolio has multiple managers, all of these managers will be covered by the investment guidelines.

- B. The investment guidelines shall be submitted to the insurer for underwriting review before the contract becomes effective.

- C. If the insurer accepts a proposed change to the investment guidelines or allows the contract to operate in accordance with investment guidelines not meeting the criteria established in Section 5E(1)(j), approval of the non-conforming investment guidelines must be obtained pursuant to Section 5B and Section 5C as appropriate.

Section 8. Purchase of Annuities

For contracts that are group annuity contracts, and that make available to the contractholder the purchase of immediate or deferred annuities for the benefit of individual members of the group, an annuity may not be purchased without the delivery of the contractually agreed upon consideration in cash to the insurer from the segregated portfolio for allocation to the insurer's general account or a separate account. The insurer shall collect adequate consideration for the cost of annuities purchased under contract option by transfer from the segregated portfolio.

Section 9. Unilateral Contract Terminations

A contract subject to this regulation shall allow the insurer to unilaterally and immediately terminate, without future liability of the insurer or obligation to provide further benefits, upon the occurrence of any one of the following events that is material and that is not cured within thirty (30) days following the insurer's discovery of it:

- A. The investment guidelines are changed without the advance consent of the insurer and the investment manager is not controlling, controlled by or under common control with the insurer;
- B. The segregated portfolio, if managed by an entity that is not controlling, controlled by or under common control with the insurer, is invested in a manner that does not comply with the investment guidelines; or
- C. Investment discretion over the segregated portfolio is exercised by or granted to anyone other than the investment manager.

Section 10. Reserves

- A. Asset maintenance requirements for segregated portfolios governed by this regulation.

(1) At all times an insurer shall hold minimum reserves in the general account or one or more separate accounts, as appropriate, equal to the excess, if any, of the value of the guaranteed contract liabilities, determined in accordance with Paragraphs (6) and (7) of this subsection, over the market value of the assets in the segregated portfolio; less the deductions provided for in Paragraph (2) of this subsection. The reserve requirements of this subsection shall be applied on a contract-by-contract basis.

(2) In determining compliance with the asset maintenance requirement and the reserve for guaranteed contract liabilities specified in Paragraph (1) of this subsection, the insurer shall deduct a percentage of the market value of an asset as follows:

- (a) For debt instruments, the percentage shall be the NAIC asset valuation reserve "reserve objective factor," but the factor shall be increased by fifty percent (50%) percent for the purpose of this calculation if the difference in durations of the assets and liabilities is more than one year.

(b) For assets that are not debt instruments, the percentage shall be the NAIC asset valuation reserve "maximum reserve factor."

(3) To the extent that guaranteed contract liabilities are denominated in the currency of a foreign country and are supported by segregated portfolio assets denominated in the currency of the foreign country, the percentage deduction for these assets under Paragraph (2) of this subsection shall be that for a substantially similar investment denominated in the currency of the United States.

(4) To the extent that guaranteed contract liabilities are denominated in the currency of the United States and are supported by segregated portfolio assets denominated in the currency of a foreign country, and to the extent that guaranteed contract liabilities are denominated in the currency of a foreign country and are supported by segregated portfolio assets denominated in the currency of the United States, the percentage deduction for debt instruments under Paragraph (2) of this subsection shall be increased by fifteen percent (15%) of the market value of the assets unless the currency exchange risk on the assets has been adequately hedged, in which case the percentage deduction under Paragraph (2) of this subsection shall be increased by one-half percent (.5%). No guaranteed contract liabilities denominated in the currency of a foreign country shall be supported by segregated portfolio assets denominated in the currency of another foreign country without the approval of the Commissioner. For purposes of this paragraph, the currency exchange risk on an asset is deemed to be adequately hedged if:

(a) It is an obligation of

(i) A jurisdiction that is rated in one of the two (2) highest rating categories by an independent nationally recognized United States rating agency acceptable to the commissioner;

(ii) Any political subdivision or other governmental unit of such a jurisdiction, or any agency or instrumentality of jurisdiction, political subdivision or other governmental unit; or

(iii) An institution that is organized under the laws of any such jurisdiction; and

(b) At all times the principal amount of the obligation and scheduled interest payments on the obligation are hedged against the United States dollar pursuant to contracts or agreements that are:

(i) Issued by or traded on a securities exchange or board of trade regulated under the laws of the United States or Canada or a province of Canada;

(ii) Entered into with a United States banking institution that has assets in excess of \$5 billion and that has obligations outstanding, or has a parent corporation that has obligations outstanding, that are rated in one of the two (2) highest rating categories by an independent, nationally recognized, United States rating agency, or with a broker-dealer registered with the Securities and Exchange Commission that has net capital in excess of \$250 million; or

(iii) Entered into with any other banking institution that has assets in excess of \$5 billion and that has obligations outstanding, or has a parent corporation that has obligations outstanding, that are rated in one of the two (2) highest rating categories by an independent, nationally recognized, United States rating agency and that is organized under the laws of a jurisdiction that is rated in one of the two (2) highest rating categories by an independent, nationally recognized United States rating agency.

(5) These contracts may provide for the allocation to one or more separate accounts of all or any portion of the amount needed to meet the asset maintenance requirement. If the contract provides that the assets in the separate account shall not be chargeable with liabilities arising out of any other business of the insurer, the insurer shall maintain in a distinct separate account that is so chargeable:

(a) That portion of the amount needed to meet the asset maintenance requirement that has been allocated to separate accounts; less

(b) The amounts contributed to separate accounts by the contractholder in accordance with the contract and the earnings on the contract.

(6) For purposes of this section, the minimum value of guaranteed contract liabilities is defined to be the sum of the expected guaranteed contract benefits, each discounted at a rate corresponding to the expected time of payment of the contract benefit that is not greater than the maximum multiple of the spot rate supportable by the expected return from the segregated portfolio assets, and in no event greater than 105 percent of the spot rate as described in the plan of operation (pursuant to Section 5E) or the actuary's opinion and memorandum, (pursuant to Section 10B), except that if the expected time of payment of a contract benefit is more than thirty (30) years, it shall be discounted from the expected date of payment to year thirty (30) at a rate of no more than eighty percent (80%) of the thirty-year spot rate and from year thirty to the date of valuation at a rate not greater than 105 percent of the thirty-year spot rate.

(7) In calculating the minimum value of guaranteed contract benefits:

(a) All guaranteed benefits potentially available to the contractholder on an ongoing basis shall be considered in the valuation process and analysis, and the ultimate reserve held must be sufficient to fund the greatest present value of each independent guaranteed contract benefit. For purposes of this subparagraph, the right granted to the contractholder to exit the contract by discharging the insurer of its guarantee obligation under the contract and taking control of the assets in the segregated portfolio shall not be considered a guaranteed benefit.

(b) To the extent that future guaranteed cash flows are dependent upon the benefit responsiveness of an employer-sponsored plan, a best estimate based on company experience, or other reasonable criteria if company experience is not available, shall be used in the projections of future cash flows.

B. Actuarial opinion and memorandum for segregated portfolios governed by this regulation.

(1) An insurer that issues a synthetic guaranteed investment contract subject to this regulation shall submit an actuarial opinion and, upon request, a memorandum to the commissioner annually by March 1 following the December 31 valuation date showing the status of the accounts as of the prior December 31. The actuarial opinion and memorandum shall be in form and substance satisfactory to the commissioner.

Drafting Note: The state may wish to include the information contained in the actuarial opinion and memorandum as a part of its overall filing requirements, rather than mandating a separate filing for synthetic guaranteed investment contracts.

~~(2) The actuarial opinion shall state that, after taking into account any risk charge payable, the segregated portfolio assets, and the amount of any reserve liability with respect to the asset maintenance requirement, the account assets make good and sufficient provision for contract liabilities. The opinion shall be accompanied by a certificate of an officer of the company responsible for the monitoring of compliance with the asset maintenance and reserve requirements for the segregated portfolios, describing the extent to and manner in which during the preceding year:~~

~~(a) Actual benefit payments conformed to the benefit payment estimated to be made as described in the plan of operation;~~

~~(b) The level of reserves, if any, was appropriate in view of such factors as the nature of the guaranteed contract liabilities and losses experienced in connection with account contracts;~~

~~(c) After taking into account any reserve liability with respect to the asset maintenance requirement, the amount of the account assets satisfied the asset maintenance requirement;~~

~~(d) The determination of the fair market value of the segregated portfolio conformed to the valuation procedures described in the plan of operation, including a statement of the procedures and sources of information used during the year;~~

~~(e) The fixed-income segregated portfolio conformed to and justified the rates used to discount contract liabilities for valuation pursuant to Section 10A(6);~~

~~(f) Any rates used pursuant to Section 10A(6) to discount guaranteed contract liabilities and other items applicable to the segregated portfolio were modified from the rates described in the plan of operation filed pursuant to Section 5E; and~~

~~(g) Any assets were transferred to or from the insurer's general account, or any amounts were paid to the insurer by any contractholder to support the insurer's guarantee.~~

~~(3) The actuarial opinion shall cover the applicable points set forth in Section [insert regulatory reference] of these regulations.~~

~~(4) The actuarial memorandum shall:~~

~~(a) Substantially conform with those portions of Section [insert regulatory reference to Actuarial Opinion and Memorandum Regulation] of these regulations that are applicable to asset adequacy testing and either:~~

~~(i) Demonstrate the sufficiency of account assets based upon cash flow analysis, or~~

~~(ii) Explain why cash flow analysis is not appropriate, describe the alternative methodology of asset adequacy testing used, and demonstrate the sufficiency of account assets under that methodology;~~

~~(b) Clearly describe the assumptions the qualified actuary used in support of the actuarial opinion, including any assumptions made in projecting cash flows under each class of assets, and any dynamic portfolio hedging techniques utilized and the tests performed on the utilization of the techniques;~~

~~(c) Clearly describe how the qualified actuary has reflected the risk of default on obligations and mortgage loans, including obligations and mortgage loans that are not investment grade;~~

- (d) ~~If the plan of operation provides for investments in segregated portfolio assets other than United States government obligations, demonstrate that the rates used to discount contract liabilities pursuant to Section 10A(6) conservatively reflect expected investment returns, taking into account any foreign exchange risks;~~
 - (e) ~~If the contracts provide that in certain circumstances they would cease to be funded by a segregated portfolio and, instead would become contracts funded by the general account, clearly describe how any increased reserves would be provided for if and to the extent these circumstances occurred;~~
 - (f) ~~State the amount of reserves and supporting assets as of December 31 and where the reserves are shown in the annual statement; and~~
 - (g) ~~State the amount of any contingency reserve carried as part of surplus.~~
- (2) The actuarial memorandum required by this regulation is deemed to be confidential to the same extent, and under the same conditions, as the actuarial memorandum required by Section 3 of the NAIC Model Standard Valuation Law.

Drafting Note: A thorough review should be performed of the specific laws and regulations in a state which may affect the confidential status of the memorandum.

- (3) The actuary signing the opinion required by this regulation will be appointed or retained to prepare the opinion, either directly by or by the authority of the board of directors through an executive officer of the company. The actuary appointed according to the preceding procedure must meet the qualification standards as set forth in Section 5.B. of the NAIC Actuarial Opinion and Memorandum Model Regulation. Except in cases of fraud or willful misconduct, the appointed actuary shall not be liable for damages to any person (other than the insurance company and the commissioner) for any act, error, omission, decision, or conduct with respect to the actuary's opinion.
- (4) The statement of actuarial opinion submitted in accordance with Section 10.B. (1) shall consist of:
- (a) A paragraph identifying the appointed actuary and his or her qualification;
 - (b) A scope paragraph identifying the subjects on which the opinion is to be expressed and describing the scope of the appointed actuary's work;
 - (c) A reliance paragraph describing those areas, if any, where the appointed actuary has deferred to other experts in developing data, procedures or assumptions;
 - (d) An opinion paragraph expressing the appointed actuary's opinion with respect to the adequacy of any risk charges payable, the segregated portfolio, and the amount of any reserve liability with respect to the asset maintenance requirement, that the account assets make adequate provision to mature the contract liabilities; and,
 - (e) One or more additional paragraphs may be needed in individual company cases as follows:
 - (i) If the appointed actuary considers it necessary to state a qualification of his or her opinion;
 - (ii) If the appointed actuary must disclose an inconsistency in the method of analysis used at the prior opinion date with that used for this opinion;
 - (iii) If the appointed actuary chooses to add a paragraph briefly describing the assumptions which form the basis of the actuarial opinion.
- (5) Contents of the opinion paragraph of the actuarial opinion.
- (a) The actuarial opinion shall state that, after taking into account any risk charge payable, the segregated portfolio assets, and the amount of any reserve liability with respect to the asset maintenance requirement, the account assets make adequate provision for contract liabilities.
 - (b) The opinion shall also state that:
 - (i) Reserves for contract liabilities are calculated pursuant to the requirements of Section 10.A. (1);
 - (ii) After taking into account any reserve liability with respect to the asset maintenance requirement, the amount of the account assets satisfied the asset maintenance requirement;
 - (iii) The fixed-income segregated portfolio conformed to and justified the rates used to discount contract liabilities for valuation pursuant to Section 10.A. (6);

(iv) Whether any rates used pursuant to Section 10.A. (6) to discount guaranteed contract liabilities and other items applicable to the segregated portfolio were modified from the rate or rates described in the plan of operation filed pursuant to Section 5 E; and,

(v) The level of risk charges, if any, retained in the general account was adequate in view of such factors as the nature of the guaranteed contract liabilities and losses experienced in connection with account contracts and other pricing factors including the cost of capital.

(6) The opinion shall be accompanied by a certificate of an officer of the insurance company responsible for monitoring compliance with the asset maintenance requirements for synthetic guaranteed investment contracts describing the extent to, and manner in which, during the preceding year:

(a) Actual benefit payments conformed to the benefit payment estimated to be made as described in the plan of operation;

(b) The determination of the fair market value of the segregated portfolio conformed to the valuation procedures described in the plan of operation, including a statement of the procedures and sources used during the year; and,

(c) Any assets were transferred to or from the insurer's general account, or any amounts were paid to the insurer by any contractholder to support the insurer's guarantee.

(7) The actuarial memorandum shall:

(a) Substantially conform with those portions of Section [insert reference to section of the regulations related to actuarial memorandum] of these regulations that are applicable to asset adequacy testing and either:

(i) Demonstrate the adequacy of account assets based upon cash flow analysis, or

(ii) Explain why cash flow testing analysis is not appropriate, describe the alternative methodology of asset adequacy testing used, and demonstrate the adequacy of account assets under that methodology;

(b) Clearly describe the assumptions the qualified actuary used in support of the actuarial opinion, including any assumptions made in projecting cash flows under each class of assets, and any dynamic portfolio hedging techniques utilized and the tests performed on the utilization of the techniques;

(c) Clearly describe how the qualified actuary has reflected the cost of capital.

(d) Clearly describe how the qualified actuary has reflected the risk of default on obligations and mortgage loans, including obligations and mortgage loans that are not investment grade;

(e) Clearly describe how the qualified actuary has reflected withdrawal risks, if applicable, including a discussion of the positioning of the contracts within the benefit withdrawal priority order pertaining to the contracts;

(f) If the plan of operation provides for investments in segregated portfolio assets other than United States government obligations, demonstrate that the rates used to discount contract liabilities pursuant to Section 10A(6) conservatively reflect expected investment returns, taking into account any foreign exchange risks;

(g) If the contracts provide that in certain circumstances they would cease to be funded by a segregated portfolio and, instead would become contracts funded by the general account, clearly describe how any increased reserves would be provided for if and to the extent these circumstances occurred;

(h) State the amount of account assets maintained in a separate account that are not chargeable with liabilities arising out of any other business of the insurance company;

(i) State the amount of reserves and supporting assets as of December 31 and where the reserves are shown in the annual statement; and

(j) State the amount of any contingency reserve carried as part of surplus.

(k) State the market value of the segregated asset portfolio.

(l) Where separate account assets are not chargeable with liabilities arising out of any other business of the insurance company, describe how the level of risk charges payable to the general account provides an appropriate compensation for the risk taken by the general account.

C. When the insurer issues a synthetic guaranteed investment contract and complies with the asset maintenance requirements of Section 10A, it need not maintain an asset valuation reserve with respect to those account assets.

~~D. This section provides for reserve valuation for segregated portfolios governed by this regulation.~~

~~(1) Reserves for synthetic guaranteed investment contracts subject to this regulation shall be an amount equal to the sum of the following:~~

- ~~(a) The amounts determined as the minimum reserves as required under Section 10A(1);~~
- ~~(b) Any additional amount determined by the insurer's qualified actuary as necessary to make good and sufficient provision for all of the contract liabilities; and~~
- ~~(c) Any additional amount determined as necessary by the commissioner due to the nature of the benefits.~~

D. This section describes the reserve valuation requirements for contracts subject to this regulation.

(1) Reserves for synthetic investment contracts subject to this regulation shall be an amount equal to the sum of the following:

- (a) The amounts determined as the minimum reserve as required under Section 10.A. (1);
- (b) Any additional amount determined by the insurer's qualified actuary as necessary to make adequate provision for all contract liabilities; and
- (c) Any additional amount determined as necessary by the commissioner due to the nature of the benefits.

(2) The amount of any reserves required by Paragraph (1) of this subsection may be established by either:

- (a) Allocating sufficient assets to one or more separate accounts; or
- (b) Setting up the additional reserves in the general account.

Section 11. Severability

If any provision of this regulation or its application to any person or circumstances is judged invalid by a court of competent jurisdiction, the judgment shall not affect or impair the validity of the other provisions of this regulation.

Section 12. Effective Date

This regulation shall take effect [insert date].

ATTACHMENT TWO

Equity-Indexed Products Working Group Boston, Massachusetts June 23, 1998

The Equity-Indexed Products Working Group of the Life Insurance and Annuities (A) Committee met in Salon HI of the Marriott Copley Place Hotel in Boston, Mass., at 8 a.m. on June 23, 1998. Jerry Fickes (N.M.) chaired the meeting. The following working group members or their representatives were present: Roger Strauss (Iowa); Lester Dunlap (La.); Frank Cote (Mont.); Dan Keating (Okla.); and Leslie Jones (S.C.).

The meeting opened with a presentation from Cynthia DiBiase (NFC Consulting Group) on Equity-Indexed Annuity (EIA) Training and Education. At the conclusion of that presentation, Tom Foley (N.D.) asked Ms. DiBiase if she believed that the current sales practices are adequately educating consumers relative to EIA product features and volatilities. Ms. DiBiase responded by saying that she believes that agent understanding of the product is improving, and that this is facilitating greater consumer understanding. She also stated that it is critical that the product be presented as a fixed annuity with the standard basic elements and guarantees, and that the equity component should only be mentioned after the other product features are emphasized.

Both Mr. Foley and Jerry Fickes (N.M.) asked how the activities of "bad" agents could be curtailed. Ms. DiBiase responded that it would be helpful for the NAIC to create a list of "do's and don'ts" to guide agents in their sale activities. Ms. DiBiase stated that it would be most effective for the NAIC to work with the companies in distributing that and other educational material to the agents. She also said that ongoing training and monitoring of the agents is important.

Sam Meyer (S.D.) then asked Ms. DiBiase if National Association of Security Dealers (NASD) registered agents are better suited than other agents to sell EIAs. Ms. DiBiase said that while some basic understanding of the stock market is needed, it is more important that the agent makes a sales presentation that achieves the right balance between the traditional annuity features and the equity component. Mr. Meyer stated that it would be helpful to receive more input relative to agent licensing and training material.

Dan Keating (Okla.) noted that differing marketing systems will require differing methods for communicating with and educating agents. Paul DeAngelo (N.J.) asked if the sales material consumers are currently receiving adequately explains the nature of EIAs, i.e., the equity component. Ms. DiBiase stated that there is a lot of information contained in the material, but she thinks the material generally does "a decent job." Mr. Foley asked if the "balancing language" concept is being implemented. Ms. DiBiase said there is room for improvement in this respect.

Next, Reese Boyd (American Council of Life Insurance—ACLI) gave an overview of another survey on agent training and education. He stated that companies generally are going to great lengths to train agents. He said most companies have training manuals, and that some companies utilize videos. He also mentioned that some companies have training in the field, and that one company of which he is aware utilizes weekly conference calls. In conclusion, he emphasized two points: 1) companies have a strong interest in assuring agents are well trained, and 2) companies have shown a lot of innovation in their training techniques. Mr. Fickes asked Mr. Boyd to obtain samples of training materials utilized by companies and send them to Carolyn Johnson (NAIC/SSO). Mr. Fickes then asked Mr. Boyd if the Insurance Marketplace Standards Association (IMSA) reviews the quality of agent training relative to EIAs. Mr. Boyd responded that IMSA is more "company-focused" than "agent-focused," but that the company has to demonstrate that it is doing appropriate agent training. Mr. Boyd also stated that, in the future, IMSA might do more in regards to agent training.

Next, Mr. Fickes reviewed the proposed work plan for the working group (Attachment Two-A). Mr. Keating moved and Leslie Jones (S.C.) seconded a motion to approve the work plan. The motion passed. Mr. Fickes then stated that a copy of the NAIC's *Market Conduct Examiners Handbook* will be provided to all working group members to assist them in this effort. He said that a conference call will be scheduled in late July or early August to continue the working group's discussions.

Also, a survey of the states regarding their contract filing guidelines for equity-indexed products was distributed (Attachment Two-B).

Having no further business, the Equity-indexed Products Working Group adjourned at 9:30 a.m.

ATTACHMENT TWO-A

Work Plan for the Equity-Indexed Annuities Working Group

| Task | How to be Accomplished | Target Date |
|---|---|---------------------------------|
| 1. Review state contract filing guidelines | Staff has solicited input from states. Memo has filing guidelines attached | June 1998 |
| 2. Discuss going forward with contract review issues. | Discuss options at June 1998 meeting: (1) develop recommendations from working group (2) distribute documents from states and encourage states to choose helpful material to include in their own guidelines (3) other: | December 1998 |
| 3. Prepare recommendations on market conduct enforcement for review by EX3 Subcommittee | Review pertinent sections of <i>Market Conduct Examiners Handbook</i> and suggest any enhancements for equity-indexed products | September 1998 |
| 4. Review agents training and education issues | Hear presentation from NAVA on agents training and education for variable products Consider alternatives and make recommendations on agents education and training: (1) require same as for variable (2) add education requirements for life agents on state level (3) require company training to be demonstrated as part of product filing (4) other | June 1998 September 1998 |
| 5. Consider guaranty fund issues | Discuss whether to make any recommendations to the Insolvency (EX5) Subcommittee | September 1998 |

Equity-Indexed Products Filing Guidelines
From Carolyn J. Johnson, CLU (NAIC)
June 10, 1998

| States | Have Guidelines | No Guidelines | Did Not Respond |
|----------------------|-----------------|---------------|-----------------|
| Alabama | | No | |
| Alaska | | No | |
| American Samoa | | No | |
| Arizona | Yes (Internal) | | |
| Arkansas | | No | |
| California | Yes | | |
| Colorado | | No | |
| Connecticut | | No | |
| Delaware | | No | |
| District of Columbia | | | X |
| Florida | | | X |
| Georgia | | | X |
| Guam | | No | |
| Hawaii | | No | |
| Idaho | | No | |
| Illinois | Yes | | |
| Indiana | Yes | | |
| Iowa | | No | |
| Kansas | | | X |
| Kentucky | | No | |
| Louisiana | | No | |
| Maine | | No | |
| Maryland | Yes | | |
| Massachusetts | | No | |
| Michigan | | No | |
| Minnesota | Yes | | |
| Mississippi | | No | |
| Missouri | Yes | | |
| Montana | | No | |
| Nebraska | | | X |
| Nevada | | | X |
| New Hampshire | | No | |
| New Jersey | Yes | | |
| New Mexico | Yes | | |
| New York | | | X |
| North Carolina | Yes | | |
| North Dakota | Yes | | |
| Ohio | | No | |
| Oklahoma | Yes | | |
| Oregon | | No | |
| Pennsylvania | Yes | | |
| Puerto Rico | | | X |
| Rhode Island | | No | |
| South Carolina | Yes | | |
| South Dakota | | No | |
| Tennessee | | No | |
| Texas | Yes | | |
| Utah | Yes | | |
| Vermont | Yes | | |
| Virgin Islands | | | X |
| Virginia | Yes | | |
| Washington | Yes | | |
| West Virginia | | | X |
| Wisconsin | | No | |
| Wyoming | Yes | | |

ATTACHMENT THREE

Life Disclosure Working Group
 Boston, Massachusetts
 June 21 and 23, 1998

The Life Disclosure Working Group of the Life Insurance and Annuities (A) Committee met in Salon JK of the Marriott Copley Place Hotel in Boston, Mass., June 21 and 23, 1998. Tom Foley (N.D.) chaired the meeting. The following working group members were present: John Hartnedy (Ark.); Sheldon Summers (Calif.); Roger Strauss (Iowa); Lester Dunlap (La.); Cindy Martin (Mass.); Paul DeAngelo (N.J.); Jerry Fickes (N.M.); Tom Jacks (N.C.); and Dan Keating (Okla.).

1. Consider Deferred Annuities Buyer's Guide

Tom Foley (N.D.) said the Life Disclosure Working Group adopted an Equity-Indexed Annuities Buyer's Guide at the Spring National Meeting in Salt Lake City. Companies were encouraged to use that document voluntarily until it is incorporated as an appendix to the Fixed Deferred Annuities Buyer's Guide now being developed. Since the Spring National Meeting the working group has made further amendments to the Deferred Annuities Buyer's Guide and it has been reviewed by Brenda Cude (University of Illinois Cooperative Extension Service) to make the document more consumer-friendly. Reva Kinslick (Prudential) said the draft before the working group contains all of Ms. Cude's revisions except ones the industry was not comfortable with. Several representatives from the technical resource advisors met with Ms. Cude to resolve questions. Mr. Foley said the intent is to give the guide without the appendix to those who are not considering purchase of an equity-indexed product, and to include the appendix for equity-indexed annuities to those considering purchase of that type of product. Mr. Foley said the group would go through the draft section by section for final review before adoption. Cindy Martin (Mass.) suggested adding a table of contents to the document. Mr. Foley asked if this should be just the bold headings or subheading also. Ms. Martin suggested using the bold headings. Mr. Foley said this would be added to the document and then a final decision made after review of the entire document. Ms. Kinslick said she discussed this possibility with Ms. Cude and they agreed that it was not appropriate to include a table of contents so that the potential buyer would read the whole guide rather than zero in on certain parts. Paul DeAngelo (N.J.) noted that none of the other guides that have been prepared include a table of contents. There was extensive discussion on the section titled "How is Interest Credited to My Fixed Deferred Annuity." Mr. Foley asked if a reader would understand from reading this section that the company has complete discretion in setting the rate for renewal years. Bob Wright (Va.) suggested adding a sentence in bold that says "These rates are generally set at the sole discretion of the insurance company." The working group members decided to change the title to "How is the Interest Rate Determined for My Fixed Deferred Annuity?" and to rewrite the information under that to explain more clearly the difference between the current interest rate and the renewal interest rate. As the working group and the audience reviewed the draft several more suggestions were made for changes. Mr. Foley assigned small groups of individuals to prepare language for each of the areas identified and to provide it to Carolyn Johnson (NAIC/SSO) within 24 hours so that the guide could be revised and reviewed again when the working group reconvenes. Another area the working group decided needed extensive change was the area that discussed two-tier annuities. The more general term "multiple benefit plans" is included in the draft but the language needs clarification.

The working group reviewed the equity-indexed annuities appendix to the buyer's guide and declined to make extensive changes to that part. Ms. Martin said that Massachusetts is taking the position that equity-indexed annuities are variable products. She suggested this language should be included in the guide. Mr. DeAngelo asked if the state can decide that equity-indexed products are variable without input from the Securities and Exchange Commission (SEC). He asked if the SEC will then regulate the product. Ms. Martin responded that Massachusetts is taking this position based on a reading of its law and is holding hearings on the issue. Mr. DeAngelo asked, if Massachusetts decides these are variable products, will Massachusetts petition the SEC to regulate these products or will the state regulate the prospectus. Ms. Martin said that Massachusetts does not have jurisdiction to regulate the prospectus but would apply its variable annuity regulation. The working group members decided not to include reference to the Massachusetts position because it conflicts with the response of the Life Insurance and Annuities (A) Committee to the SEC. They decided it was not appropriate for the working group to go in the opposite direction.

Charlotte Liptak (Transamerica) said there were several sentences that were deleted from the Equity-Indexed Buyer's Guide but were not moved to the main guide and need to be put back in place again. Mr. Foley said this raises a good general issue: do we assume that whatever we say for fixed annuities applies here also? Ms. Liptak responded that it is clear the material in the general guide applies to equity-indexed annuities also. She suggested it may be that the equity-indexed annuities portion needs to begin by stating that the material in the main guide applies to equity-indexed products. Ms. Lanam said that rather than adding information to the equity-indexed guide, it may be appropriate to take out repetition of material in the general fixed annuities buyer's guide. Mr. DeAngelo spoke against taking out too much information. He said if we put a table of contents in the document people will not read all of the guide so it is especially important to repeat information in each section.

When the working group reviewed the buyer's guide after reconvening, Mr. Foley suggested that the amendments were too extensive to allow adoption of the buyer's guide at the Summer National Meeting. He asked that regulators and interested parties review the draft (Attachment Three-A) and make comments to Ms. Johnson by July 15. Ms. Johnson will compile the comments and a conference call to discuss the buyer's guide will take place in late July or early August. After that Ms. Cude will be asked to review the buyer's guide one final time.

2. Discuss Draft of Annuity Disclosure and Sales Illustrations Model Regulation

At the May 20, 1998, conference call the working group discussed proposed new Sections 5 and 6 prepared by Mr. Foley. Mr. Foley said he sensed some support for Section 6 but his understanding was that the working group was more comfortable with

the Section 5 language drafted at the interim meeting in February 1998. He said the working group needs to go through the rest of the model and discuss illustrations and how to make them supportable. It will also be necessary to discuss whether tabular detail and a numeric summary are needed and how they should look. Mr. DeAngelo said, if the requirements for illustrations are any different from those of life insurance, there will be a systems delay. He suggested there is some merit to holding off on the illustrations requirement and doing it at the same time as the requirements for variable life. He opined that companies likely would not be able to make changes in their illustrations systems until after the year 2000. He suggested the working group focus on getting out the disclosure portion of the model including the buyer's guide so that companies can begin using that. He expressed concern that the regulators will get bogged down on the illustration parts of the regulation. He opined that it makes sense to deal with the disclosure portion of the regulation first and wait with the illustration portion until later. Roger Strauss (Iowa) agreed that the process has gone on for quite a while and will take longer yet. He suggested finishing the disclosure portion and reviewing Section 5 and then coming back to the illustration portion of the regulation later. The actuarial issues will take some time to resolve, which will further delay the development of an illustration regulation.

Mr. Foley summarized that the proposal on the table is to take basically the first five sections of the Annuity Disclosure and Sales Illustration Model Regulation and the buyer's guide and distribute those as a new model. Later illustration requirements would be added. He asked if any of the regulators were opposed. None of the regulators spoke in opposition to the proposal. Mr. Strauss noted that the regulators are being told that not a lot of companies illustrate annuities in any case so it does not seem appropriate to hold up the process to develop illustration standards. Mr. Foley said the working group needs to talk about the timing of the delivery of the buyer's guide and include that in the disclosure regulation. Bill Carmello (N.Y.) asked if the supportability discussion will be put off if the draft only contains Sections 1 through 5. Mr. Foley responded in the affirmative except that the draft now contains a provision saying the renewal rate can be shown, even though it is not guaranteed, if it is supportable. That will be meaningless at this point so the working group will have to decide whether to show guarantees only until supportability is better defined.

Linda Lanam (Life of Virginia) said some technical resource advisors have a recommendation for Section 5A. The insurer agrees to make reasonable efforts to deliver the buyer's guide as early in the sales process as practical and the proposal states that if the buyer's guide is delivered only at the time of the contract delivery, an additional period of 10 days would be added to the free-look period. A suggested drafting note contains suggestions about how a company can demonstrate it has made reasonable efforts to distribute a buyer's guide early in the process. Ms. Lanam asked the working group to recognize the fact that annuities are sold in a variety of ways, many with no face-to-face contact. Mr. DeAngelo said he had no problem with the suggestion from the technical resource advisors as long as it did not include the concept that a face-to-face meeting could occur without giving the buyer's guide. He said he was in favor of this for direct response but wanted the buyer's guide delivered at the time of application for a face-to-face meeting. Mr. Foley said that it seemed to him that a buyer's guide would be part of any face-to-face meeting. Ms. Lanam said that the individual will receive a disclosure document. Mr. Foley responded that the disclosure document without the buyer's guide is not very helpful. Mr. Foley said that he and Ms. Johnson would revise the draft regulation in response to the comments received and the suggestions from the technical resource advisors (Attachment Three-B). Comments on the draft should be received by July 20, 1998, and a conference call will be held shortly thereafter to discuss the comments.

3. Report on Variable Life Insurance and the SEC

George Coleman (Prudential) introduced Carl Wilkerson (American Council of Life Insurance—ACLI), who he said would bring the working group up-to-date on the work of the SEC and its current proposal. Mr. Wilkerson said variable life insurance has both insurance and securities characteristics and is regulated both by the SEC and the state insurance departments. A recent SEC proposal for a form specific to variable life insurance is a significant proposal. The purpose of the project is to give consumers a user-friendly document to provide information. Mr. Wilkerson said the ACLI submitted a proposal to the SEC in 1993 and commented that a standardized illustration is not a good comparison vehicle for consumers. It is only good for showing policy mechanics. The package recently proposed by the SEC includes simplification and many of the recommendations from the ACLI. There is a hypothetical illustration and an abbreviated prospectus. Many of the limitations included in the proposal are similar to those in the NAIC's Life Insurance Illustrations Model Regulation. The SEC's proposal includes a question of whether there should be a cap of 10% on the hypothetical illustrations. The proposal includes two hypothetical illustrations; one at 0% and one other rate. The comment deadline for the SEC proposal is July 1, 1998. Mr. Wilkerson said the life insurance industry will support the simplified format, the short prospectus, and the optional hypothetical illustration. The industry may oppose the 10% cap and instead support the current 12% cap for a hypothetical illustration. The industry will likely recommend that the proposal provide a structure for a personalized illustration and will seek to extrapolate from the NAIC model. Mr. Wilkerson opined that the SEC enjoyed its interaction with the NAIC and would welcome further interaction. He offered to share the response that the ACLI prepares for the SEC.

Mr. Foley said that a subgroup of the Life Disclosure Working Group met on more than one occasion with the SEC and suggested that it was perhaps time to do this again. He asked any regulators interested in participating in this subgroup to express that interest to Ms. Johnson. Cindy Martin (Mass.) offered to be a part of this group.

4. Report from AAA on Self-Support and Lapse-Support Tests

Barbara Lautzenheiser (Lautzenheiser & Associates) said the American Academy of Actuaries (AAA) has spent more than 2,000 hours since the last report in March on the issue of supportability. The life insurance tests are inappropriate for annuities and new tests must be created. Ms. Lautzenheiser emphasized the importance of input from the working group, other regulators, and insurance company actuaries on the report (Attachment Three-C). She said the testing is complicated and tests will be narrowed and refined in response to the comments. Richard Ostuw (Deloitte & Touche), Lisa Reitano (John Hancock

Mutual), Elizabeth Sutherland (Teachers Insurance and Annuity Association), Roger Wiard-Bauer (Life USA), and Doug Doll (Tillinghast-Towers Perrin), gave portions of the report from the AAA.

6. Discussion of Life Insurance Illustrations Model Regulation

Mr. Ostuw reported that the AAA conducted a survey of first-year company experience under the Life Insurance Illustrations Model Regulation (Attachment Three-D). Mr. Foley thanked the AAA for its work and commented that this survey will be helpful to the working group when it considers amendments that might be necessary to the life illustrations regulation.

7. Adopt Minutes of May 20, 1998, Conference Call

Mr. Fickes moved and John Hartnedy (Ark.) seconded a motion to adopt the minutes of the May 20, 1998, conference call (Attachment Three-E). The motion passed.

Having no further business, the Life Disclosure Working Group adjourned.

ATTACHMENT THREE-A

BUYER'S GUIDE TO FIXED DEFERRED ANNUITIES

Draft: June 21, 1998

Drafting Note: The language of the Fixed Deferred Annuity Buyer's Guide is limited to that contained in the following pages, or to language approved by the commissioner. Companies may purchase personalized brochures from the NAIC or may request permission to reproduce the Buyer's Guide in their own type style and format.

[The face page of the Fixed Deferred Annuity Buyer's Guide shall read as follows:]

Prepared by the National Association of Insurance Commissioners

The National Association of Insurance Commissioners is an association of state insurance regulatory officials. This association helps the various insurance departments to coordinate insurance laws for the benefit of all consumers.

This guide does not endorse any company or policy.

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It is important that you understand the differences among various annuities so you can choose the kind that best fits your needs. This guide has been written to help you understand the terms and conditions commonly found in *fixed deferred* annuity contracts. It does, however, contain a brief description of variable annuities. If you're thinking of buying an equity-indexed annuity, an appendix to this guide will give you specific information. This guide is not meant to offer legal or tax advice. At the end of this guide are questions you should ask your agent or the company. Make sure you're satisfied with the answers before you buy.

WHAT IS AN ANNUITY?

An annuity is a contract in which an insurance company makes a series of income payments at regular intervals in return for a premium or premiums you have paid. Annuities are most frequently bought for future retirement income. Only an annuity can pay an income that can be guaranteed to last as long as you live.

An annuity is neither a life insurance nor a health insurance policy. It's not a savings account or a savings certificate. You shouldn't buy an annuity to reach short-term financial goals.

Your value in an annuity contract is the premiums you've paid, plus interest credited, less any applicable charges. The value is used to figure the amount of most of the benefits that you can choose to receive from an annuity contract. How interest is credited as well as the charges and benefits are explained below.

There are two parts, or periods, in a deferred annuity. During the accumulation period, the money you put into the annuity, less any applicable charges, earns interest. The earnings grow tax-deferred as long as you leave them in the annuity. During the second period, called the payout period, income is paid to you or to someone you choose.

WHAT ARE THE DIFFERENT KINDS OF ANNUITIES?

Annuities can be classified by some general descriptions. These are explained below to help you understand the different products available and how they might meet your needs. But look at the specific terms of a contract you're considering and the Disclosure Document you receive. If your annuity is being used to fund or provide benefits under a pension plan, the terms of the pension plan will determine the benefits you receive under the plan. Contact your pension plan administrator for information.

This Buyer's Guide will focus on individual fixed deferred annuities.

Single Premium or Multiple Premium

You pay the insurance company only one payment for a single premium annuity. You make a series of payments for a multiple premium annuity. There are two kinds of multiple premium annuities. One kind is a flexible premium contract. Within set limits, you pay as much premium as you want, whenever you want. The other kind is a scheduled premium annuity, which specifies how much your payments will be and how often you'll pay them.

Immediate or Deferred

With an immediate annuity, income payments start no later than one year after you pay the premium. You usually pay for an immediate annuity with one payment.

The income payments from a deferred annuity often start many years later. Deferred annuities have an "accumulation" period, which is the time between when you start paying premiums and when income payments start. The time after income payments start is called the payout or income period.

Fixed or Variable

• Fixed

During the accumulation period of a fixed deferred annuity, your money (less any applicable charges) earns interest at rates set by the insurance company or in a way spelled out in the annuity contract. The company guarantees that it will pay no less than a minimum rate of interest. During the payout period, the amount of each income payment you receive is generally set when the payments start and will not change.

• Variable

During the accumulation period of a variable annuity, premiums (less any applicable charges) are put into a separate account of the insurance company. You decide how the company will invest those premiums, from stock, bond or other choices. The value of the separate account, and therefore, the value of your variable annuity, varies with the investment experience of the portfolios you choose. A variable annuity may give you the choice to put your money in a fixed account with guaranteed minimum interest. The premiums you put in a fixed account will be returned. There is no guarantee that you'll receive back the premiums you put in any other account. During the payout period of a variable annuity, the amount of each income payment you receive may be fixed (predetermined) or variable (changing with the value of the investments in the separate account).

HOW IS THE INTEREST RATE DETERMINED FOR CREDITED TO MY FIXED DEFERRED ANNUITY?

During the accumulation period, your money (less any applicable charges) earns interest at rates that change from time to time, determined by the insurance company. Some annuities credit interest at a rate stated in the contract. Others credit interest at a rate set by the insurance company from time to time. An indexed annuity credits interest at a rate that is linked to an external reference or index. These rates are generally set at the sole discretion of the insurance company.

Current Interest Rate

The current rate is the rate the company decides to credit to your contract at a particular time. It will be guaranteed for some time period.

- The initial rate is an interest rate the insurance company may credit for a set period of time after you first buy your annuity. Some contracts may have a temporarily increased rate, often called a bonus rate.
- The renewal rate is the rate credited by the company after the end of the initial time period. This rate will be determined by the company, as set forth in the contract, or tied to an external reference or index.

Minimum Guaranteed Rate

The minimum guaranteed interest rate is the lowest rate your annuity will earn. This rate is stated in the contract.

Initial Interest Rate

The initial rate is an interest rate the insurance company may credit for a set period of time after you first buy your annuity.

Renewal Interest Rate

The renewal rate is the rate credited by the company after the end of the initial time period.

Current Interest Rate

The current rate is the rate credited to your contract by a company at a particular time. It will be guaranteed for some time period. After that time, the company may declare a different current rate to be credited during the next period of time. The current rate is often higher than the minimum guaranteed rate.

Current interest rates vary from company to company and from product to product. The day on which you buy an annuity contract or make additional payments to your existing contract can affect the current rate credited.

Multiple Interest Rates

Some annuity contracts apply different interest rates to each premium you pay, premiums you pay during a time period, or to different portions of your accumulated value.

Other annuity contracts may have two or more accumulated values that fund different benefit options. These accumulated values may use different interest rates. You get only one of the accumulated values based on the benefit you choose.

Multiple benefit annuities are described later in this Buyer's Guide.

WHAT CHARGES MAY BE SUBTRACTED FROM MY FIXED DEFERRED ANNUITY?

Most annuities have charges relating to the cost of selling or servicing the annuity. These charges may be subtracted directly from the contract value. Ask your agent or the company to describe the charges that apply to your annuity. Some examples of charges, fees, and taxes are:

Surrender or Withdrawal Charges

To get money, you can may be able to take all or part of the value out of your annuity at any time during the accumulation period. If you take out part of the value, you may pay a *withdrawal* charge. If you take out all of the value and surrender, or terminate, the annuity, you may pay a *surrender* charge. In either case, the company may figure the charge as a percentage of the value of the contract, the premiums you've paid, or the amount you're withdrawing. The percentage may be lowered or even eliminated after you've had the contract for a stated number of years. Surrender charges are sometimes waived when a death benefit is paid.

Some annuities have stated terms. When the term is up, the contract may automatically expire or renew. You're usually given a short period of time, called a *window*, to decide if you want to renew or surrender the annuity. If you surrender during the window, you won't have to pay surrender charges. If you renew, the surrender or withdrawal charges may start over.

In some annuities, there is no charge if you surrender your contract when the company's current interest rate falls below a certain level. This may be called a *bail-out* option.

In a multiple-premium annuity, the surrender charge may apply to each premium paid for a certain period of time. This may be called a *rolling* surrender or withdrawal charge.

Some annuity contracts may have a *market value adjustment* (MVA) feature. If you surrender the annuity when the market values of the investments backing the annuity are lower than when you bought it, the company will have to sell the investments at a lower price. As a result, your cash surrender value may be lower than when you bought the annuity. On the

other hand, if market values are higher, your cash surrender value may be higher than when you bought the annuity. Since you and the insurance company share this risk, an annuity with a MVA feature may credit a higher rate than an annuity without that feature.

Be sure to read the Tax Treatment section and ask your tax advisor for information about possible tax penalties on withdrawals.

Free Withdrawal

Your annuity may have a limited *free withdrawal* feature. That lets you make one or more withdrawals without a charge. The size of the free withdrawal is often limited to a set percentage of your contract value. If you make a larger withdrawal, you may pay withdrawal charges. You may lose any interest above the minimum guaranteed rate on the amount withdrawn. Some annuities waive withdrawal charges in certain situations, such as death, confinement in a nursing home or terminal illness.

Contract Fee

A contract fee is a flat dollar amount charged either once or annually.

Transaction Fee

A transaction fee is a charge per premium payment or other transaction.

Percentage of Premium Charge

A percentage of premium charge is a charge deducted from each premium paid. The percentage may be lower after the contract has been in force for a certain number of years or after total premiums paid have reached a certain amount.

Premium Tax

Some states charge a tax on annuities. The insurance company pays this tax to the state. The amount may be subtracted when you pay your premium, when you withdraw your contract value, when you start to receive income payments, or when a death benefit is paid to your beneficiary.

WHAT ARE SOME FIXED DEFERRED ANNUITY CONTRACT BENEFITS?

Annuity Income Payments

One of the most important benefits of deferred annuities is your ability to use the value built up during the accumulation period to give you a lump sum payment or to make income payments during the payout period. Income payments are usually made monthly but you may choose to receive them less often. The size of income payments is based on the accumulated value in your annuity and the annuity's *benefit rate* in effect when income payments start. The benefit rate usually depends on your age and sex, and the annuity payment option you choose. For example, you might choose payments that continue as long as you live, as long as your spouse lives, or payments that continue for a set number of years.

There is a table of guaranteed benefit rates in each annuity contract. Most companies develop *current* benefit rates as well. These current rates are subject to change by the company at any time, but can never be less than the guaranteed benefit rates. When income payments start, the insurance company generally uses the benefit rate in effect at that time to calculate the amount of income payment you'll receive.

Companies may offer various income payment options. These options may be available to you as the owner or to another person that you name. The options are described here as if the payments are made to you.

- **Life Only** - Income payments are made for your life. No payments will be made to anyone after you die. This income payment option usually pays the highest income possible. You might choose it if you have no dependents, if you have taken care of them through other means, or if the dependents have enough income of their own.
- **Life Annuity with Period Certain** - Income payments are made for as long as you live but are guaranteed to be made for a set number of years even if you die. This *period certain* is usually 10 or 20 years. If you live longer than the period certain, you'll continue to receive payments until you die. If you die during the period certain, your beneficiary gets regular payments for the rest of that period. If you die after the period certain, your beneficiary doesn't receive any payments from your annuity. Because the "period certain" is an added benefit, each income payment will be smaller than in a life-only option.
- **Joint and Survivor** - Income payments are made as long as either you or your beneficiary lives. You may choose to decrease the amount of the payments after the first death. You may also be able to choose to have payments continue for a set length of time. Because the *survivor* feature is an added benefit, each income payment is smaller than in a life-only option.

Death Benefit

Annuity contracts may provide that, if you die before the income payments start, a death benefit will be paid to your beneficiary. The most common death benefit is the contract value or the premiums paid, whichever is more.

CAN MY ANNUITY'S HAVE MORE THAN ONE VALUE CHANGE WITH MY CHOICE OF BENEFIT?

In addition to retirement income, an annuity may provide other benefits, such as the option to use the funds for long term care. This type of annuity is often called a ~~multiple-benefit annuity or a two-tiered annuity~~. Such an annuity uses different accumulated values, depending on the type of benefit paid. For example, higher values may be used if annuity payments are for retirement benefits or long-term care benefits, or if income payments are made for more than a set minimum number of years. Lower values may be used if the annuity is surrendered or used for shorter term income payments.

Each benefit in a multiple-benefit annuity may have its own charges and credits. Benefits that use a higher accumulated value may offer premium or interest bonuses and use a higher credited interest rate. Benefits that use a lower value often have their own surrender or other charges and may use a lower credited interest rate for a number of years.

When you choose a benefit option, the accumulated value for that option is used. Once you choose a benefit option, you may not change.

While all deferred annuities offer a choice of benefits, multiple-benefit annuities or two-tiered annuities use different accumulated values based on your choice of benefits. For example, one value may be used if annuity payments are for retirement benefits or long-term care benefits, or if income payments are made for more than a set minimum number of years. A different value may be used if the annuity is surrendered or used for shorter term income payments. You can't receive more than one benefit at the same time. Some contracts allow you to choose a benefit and later switch to a different benefit. Other contracts allow you to choose a benefit and don't allow you to switch to a different benefit.

WHAT ABOUT THE TAX TREATMENT OF ANNUITIES?

Below is a general discussion about taxes and annuities. You should consult a professional tax advisor to discuss your individual tax situation.

Under current federal law, annuities receive special tax treatment. Income tax on annuities is deferred, which means you aren't taxed on the interest your money earns while it stays in the annuity. Tax-deferred accumulation isn't the same as tax-free accumulation. An advantage of tax deferral is that the tax bracket you're in when you receive annuity income payments may be lower than the one you're in during the accumulation period. You'll also be earning interest on the amount you would have paid in taxes during the accumulation period. Most states' tax laws on annuities follow the federal law.

Part of the payments you receive from an annuity will be considered as a return of the premium you've paid. You won't have to pay taxes on that part. Another part of the payments is considered interest you've earned. You'll be required to pay taxes on the part that is considered interest when you withdraw the money. You may also have to pay a 10% tax penalty if you withdraw the accumulation before age 59 1/2. The Internal Revenue Code also has rules about distributions after the death of a contract holder.

Annuities used to fund certain employee pension benefit plans (those under Internal Revenue Code Sections 401(a), 401(k), 403(b), 457 or 414) defer taxes on plan contributions as well as on interest or investment income. Within the limits set by the law, you can use pretax dollars to make payments to the annuity. When you take money out, it will be taxed.

Annuities can also be used to fund traditional and Roth IRAs under Internal Revenue Code Section 408. If you buy an annuity to fund an IRA, you'll receive a disclosure statement describing the tax treatment.

WHAT IS A "FREE LOOK" PROVISION?

Many states have laws which give you a set number of days to look at the annuity contract after you buy it. If you decide during that time that you don't want the annuity, you can return the contract and get all your money back. This is often referred to as a *free look* or *right to return* period. The free look period should be prominently stated in your contract. Be sure to read it carefully.

HOW DO I KNOW IF A FIXED DEFERRED ANNUITY IS RIGHT FOR ME?

The questions listed below may help you decide which type of annuity, if any, meets your retirement planning and financial ~~goals~~ needs. You should think about what your goals are for the money you may put into the annuity. You need to think about how much risk you're willing to take with the money. ~~Consult your financial or tax advisor.~~ Ask yourself:

- ~~How much~~ Do I need retirement income ~~will I need~~ in addition to social security, pension, savings and any other income or investment sources?
- Will I need that additional income only for myself or for myself and someone else?
- ~~How long can I leave my money in the annuity?~~
- When will I need income payments in the future?
- Does the annuity allow me to get money then?

• ~~What do I expect to use the money for in the future?~~

• ~~Is a Do I want a fixed annuity with a guaranteed interest rate most important to me, with and little or no risk of losing the principal?~~

• ~~Or, am I more interested in Do I want a variable annuity with the potential for higher earnings that aren't guaranteed and with no guarantee of return of all of my the possibility that I may risk losing principal?~~

• Or, am I somewhere in between these two extremes and willing to take some risks with an equity-indexed annuity?

WHAT QUESTIONS SHOULD I ASK MY AGENT OR THE COMPANY?

• Is this a single premium or multiple premium contract?

• Is this an equity-indexed annuity?

• ~~Is the company's current interest rate guaranteed for some period of time?~~

• What is the initial interest rate?

• Is the initial interest rate guaranteed for some time?

• Does the initial rate include a bonus rate?

• What is the guaranteed minimum interest rate?

• Are there withdrawal or surrender charges or penalties if I want to end my contract early and take out all of my money? How much are they? are these charges or penalties determined?

• Can I get a partial withdrawal without paying surrender or other charges or losing interest?

• Does my annuity waive withdrawal charges for reasons such as death, confinement in a nursing home or terminal illness?

• Is there a market value adjustment (MVA) provision in my annuity?

• Is my annuity a multiple benefit or two-tiered annuity and, if so, what other benefits are available?

• What other charges, if any, may be deducted from my premium or contract value?

• How will the accumulated value, or the way interest is credited, change if I surrender the annuity or pick a longer or shorter payout period?

• Is there a death benefit? How is it determined? Can it change?

• What income payment options are offered? Once I choose a payment option, can I change it?

FINAL POINTS TO CONSIDER

Before you decide to buy an annuity, you should review the contract. Terms and conditions of each annuity contract will vary.

You should ask yourself if, depending on your needs or age, this annuity is right for you. Taking money out of an annuity may mean you must pay taxes. Also, while it's sometimes possible to transfer the value of an older annuity into a new annuity, the new annuity may have a new schedule of charges that could mean new expenses you must pay directly or indirectly.

You should understand the long-term nature of your purchase. Be sure you plan to keep an annuity long enough so that the charges don't take too much of the money you put in. Be sure you understand the effect of all charges.

If you're buying an annuity to fund an IRA or other tax deferred retirement program, be sure that you're eligible. Also, ask if there are any restrictions connected with the program.

Remember that the quality of service that you can expect from the company and the agent is a very important factor in your decision.

When you receive your annuity contract, **READ IT CAREFULLY!!** Ask the agent and company for an explanation of anything you don't understand. Do this *before* any free look period ends.

You may want to compare information for similar contracts from several companies. Comparing products may help you make a better decision.

If you have a specific question or can't get answers you need from the agent or company, contact your state insurance department.

APPENDIX I—EQUITY-INDEXED ANNUITIES

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This is an appendix to the Buyer's Guide for Fixed Deferred Annuities. The main body of the guide contains general information about fixed deferred annuities, such as withdrawal and surrender charges and contract benefit options.

WHAT ARE EQUITY-INDEXED ANNUITIES?

An equity-indexed annuity is a fixed annuity, either immediate or deferred, that earns interest or provides benefits that are linked to an external equity reference or an equity index. The value of the index might be tied to a stock or other equity index. One of the most commonly used indices is Standard & Poor's 500 Composite Stock Price Index (the S & P 500), which is an equity index. The value of any index varies from day to day and is not predictable.

When you buy an equity-indexed annuity you own an insurance contract. You are not buying shares of any stock or index.

While immediate equity-indexed annuities may be available, this Buyer's Guide will focus on deferred equity-indexed annuities.

HOW ARE THEY DIFFERENT FROM OTHER FIXED ANNUITIES?

An equity-indexed annuity is different from other fixed annuities because of the way it credits interest to your annuity's value. Some fixed annuities only credit interest calculated at a rate set in the contract. Other fixed annuities also credit interest at rates set from time to time by the insurance company. Equity-indexed annuities credit interest using a formula based on changes in the index to which the annuity is linked. The formula decides how the additional interest, if any, is calculated and credited. How much additional interest you get and when you get it depends on the features of your particular annuity.

Your equity-indexed annuity, like other fixed annuities, also promises to pay a minimum interest rate. The rate that will be applied will not be less than this minimum guaranteed rate even if the index-linked interest rate is lower. The value of your annuity also will not drop below a guaranteed minimum. For example, many single premium contracts guarantee the minimum value will never be less than 90% of the premium paid, plus at least 3% in annual interest (less any partial withdrawals). The guaranteed value is the minimum amount available during a term for withdrawals, as well as for some annuitizations (see "Annuity Income Payments") and death benefits. The insurance company will adjust the value of the annuity at the end of each term to reflect any index increases.

WHAT ARE SOME OF THE CONTRACT FEATURES?

Two features that have the greatest effect on the amount of additional interest that may be credited to an equity-indexed annuity are the indexing method and the participation rate. It is important to understand the features and how they work together. The following describes some other equity-indexed annuity features that affect the index-linked formula.

Indexing Method

The indexing method means the approach used to measure the amount of change, if any, in the index. Some of the most common indexing methods, which are explained more fully later on, include annual reset (ratcheting), high-water mark and point-to-point.

Term

The index term is the period over which index-linked interest is calculated; the interest is credited to your annuity at the end of a term. Terms are generally from one to ten years, with six or seven years being most common. Some annuities offer single terms while others offer multiple, consecutive terms. If your annuity has multiple terms, there will usually be a window at the end of each term, typically 30 days, during which you may withdraw your money without penalty. For installment premium annuities, the payment of each premium may begin a new term for that premium.

Participation Rate

The participation rate decides how much of the increase in the index will be used to calculate index-linked interest. For example, if the calculated change in the index is 9% and the participation rate is 70%, the index-linked interest rate for your annuity will be 6.3% ($9\% \times 70\% = 6.3\%$). A company may set a different participation rate for newly issued annuities as often as each day. Therefore, the initial participation rate in your annuity will depend on when it is issued by the company. The company usually guarantees the participation rate for a specific period (from one year to the entire term). When that period is over, the company sets a new participation rate for the next period. Some annuities guarantee that the participation rate will never be set lower than a specified minimum or higher than a specified maximum.

Cap Rate or Cap

Some annuities may put an upper limit, or cap, on the index-linked interest rate. This is the maximum rate of interest the annuity will earn. In the example given above, if the contract has a 6% cap rate, 6%, and not 6.3%, would be credited. Not all annuities have a cap rate.

Floor on Equity Index-Linked Interest

The floor is the minimum index-linked interest rate you will earn. The most common floor is 0%. A 0% floor assures that even if the index decreases in value, the index-linked interest that you earn will be zero and not negative. As in the case of a cap, not all annuities have a stated floor on index-linked interest rates. But in all cases, your fixed annuity will have a minimum guaranteed value.

Averaging

In some annuities, the average of an index's value is used rather than the actual value of the index on a specified date. The index averaging may occur at the beginning, the end, or throughout the entire term of the annuity.

Interest Compounding

Some annuities pay simple interest during an index term. That means index-linked interest is added to your original premium amount but does not compound during the term. Others pay compound interest during a term, which means that index-linked interest that has already been credited also earns interest in the future. In either case, however, the interest earned in one term is usually compounded in the next.

Margin/Spread/Administrative Fee

In some annuities, the index-linked interest rate is computed by subtracting a specific percentage from any calculated change in the index. This percentage, sometimes referred to as the "margin," "spread," or "administrative fee," might be instead of, or in addition to, a participation rate. For example, if the calculated change in the index is 10%, your annuity might specify that 2.25% will be subtracted from the rate to determine the interest rate credited. In this example, the rate would be 7.75% ($10\% - 2.25\% = 7.75\%$). In this example, the company subtracts the percentage only if the change in the index produces a positive interest rate.

Vesting

Some annuities credit none of the index-linked interest or only part of it, if you take out all your money before the end of the term. The percentage that is vested, or credited, generally increases as the term comes closer to its end and is always 100% at the end of the term.

HOW DO THE COMMON INDEXING METHODS DIFFER?

Annual Reset

Index-linked interest, if any, is determined each year by comparing the index value at the end of the contract year with the index value at the start of the contract year. Interest is added to your annuity each year during the term.

High-Water Mark

The index-linked interest, if any, is decided by looking at the index value at various points during the term, usually the annual anniversaries of the date you bought the annuity. The interest is based on the difference between the highest index value and the index value at the start of the term. Interest is added to your annuity at the end of the term.

Point-to-Point

The index-linked interest, if any, is based on the difference between the index value at the end of the term and the index value at the start of the term. Interest is added to your annuity at the end of the term.

WHAT ARE SOME OF THE FEATURES AND TRADE-OFFS OF DIFFERENT INDEXING METHODS?

Generally, annuities offer *preset* combinations of features. You may have to make trade-offs to get features you want in an annuity. This means the annuity you chose may also have features you don't want.

| Features | Trade-Offs |
|--|--|
| Annual Reset Since the interest earned is "locked in" annually and the index value is "reset" at the end of each year, future decreases in the index will not affect the interest you have already earned. Therefore, your annuity using the annual reset method may credit more interest than annuities using other methods when the index fluctuates up and down often during the term. This design is more likely than others to give you access to index-linked interest before the term ends. | Your annuity's participation rate may change each year and generally will be lower than that of other indexing methods. Also an annual reset design may use a cap or averaging to limit the total amount of interest you might earn each year. |
| High-Water Mark Since interest is calculated using the highest value of the index on a contract anniversary during the term, this design may credit higher interest than some other designs if the index reaches a high point early or in the middle of the term, then drops off at the end of the term. | Interest is not credited until the end of the term. In some annuities, if you surrender your annuity before the end of the term, you may not get index-linked interest for that term. In other annuities, you may receive index-linked interest, based on the highest anniversary value to date and the annuity's vesting schedule. Also, contracts with this design may have a lower participation rate than annuities using other designs or may use a cap to limit the total amount of interest you might earn. |
| Point-to-Point Since interest cannot be calculated before the end of the term, use of this design may permit a higher participation rate than annuities using other designs. | Since interest is not credited until the end of the term, typically six or seven years, you may not be able to get the index-linked interest until the end of the term. |

WHAT IS THE IMPACT OF SOME OTHER PRODUCT FEATURES?

Cap on Interest Earned

While a cap limits the amount of interest you might earn each year, annuities with this feature may have other product features you want, such as annual interest crediting or the ability to take partial withdrawals. Also, annuities that have a cap may have a higher participation rate.

Averaging

Averaging at the beginning of a term protects you from buying your annuity at a high point, which would reduce the amount of interest you might earn. Averaging at the end of the term protects you against severe declines in the index and losing index-linked interest as a result. On the other hand, averaging may reduce the amount of index-linked interest you earn when the index rises either near the start or at the end of the term.

Participation Rate

The participation rate may vary greatly from one annuity to another and from time to time within a particular annuity. Therefore, it is important for you to know how your annuity's participation rate works with the indexing method. A high participation rate may be offset by other features, such as simple interest, averaging, or a point-to-point indexing method. On the other hand, an insurance company may offset a lower participation rate by also offering a feature such as an annual reset indexing method.

Interest Compounding

It is important for you to know whether your annuity pays compound or simple interest during a term. While you may earn less from an annuity that pays simple interest, it may have other features you want, such as a higher participation rate.

CAN I TAKE MY MONEY OUT DURING THE TERM?

~~In most cases, you can take all or part of the money out of a deferred annuity at any time during the term. There may be a cost if you do. Sometimes the cost is a stated dollar amount. In other cases, you give up index-linked interest on the amount withdrawn. Some annuities do not let you make a partial withdrawal until the end of a term.~~

WHAT WILL IT COST ME TO TAKE MY MONEY OUT EARLY?

~~If you withdraw all or part of the value in your annuity before the end of the term, a withdrawal or surrender charge may be applied. A withdrawal charge is usually a percentage of the amount being withdrawn. The percentage may be reduced or eliminated after the annuity has been in force for a certain number of years. Sometimes the charge is a reduction in the interest rate credited to the annuity.~~

In addition to the withdrawal and surrender charges information found earlier in this buyer's guide, there are additional considerations for equity-indexed annuities. Some annuities credit none of the index-linked interest or only part of it if you take out all your money before the end of the term. The percentage that is vested, or credited, generally increases as the term comes closer to its end and is always 100% at the end of the term.

IS THERE ALWAYS A CHARGE TO TAKE MY MONEY OUT EARLY?

~~Your annuity may have a limited "free withdrawal" provision. The size of the free withdrawal is limited to a set percentage of your annuity's guaranteed or accumulated value. If you make a larger withdrawal, you may pay withdrawal charges. You may also lose index-linked interest on amounts you withdraw.~~

~~Most annuities waive withdrawal charges on withdrawals made within a set number of days at the end of each term. You may, however, lose index-linked interest on withdrawals.~~

ARE DIVIDENDS INCLUDED IN THE INDEX?

Depending on the index used, stock dividends may or may not be included in the index's value. For example, the S&P 500 is a stock price index and only considers the prices of stocks. It does not recognize any dividends paid on those stocks.

HOW DO I KNOW IF AN EQUITY-INDEXED ANNUITY IS RIGHT FOR ME?

The questions listed below may help you decide which type of annuity, if any, meets your retirement planning and financial needs. You should consider what your goals are for the money you may put into the annuity. You need to think about how much risk you're willing to take with the money. Ask yourself:

Am I interested in a variable annuity with the potential for higher earnings that are not guaranteed and willing to risk losing the principal?

Is a guaranteed interest rate more important to me, with little or no risk of losing the principal?

Or, am I somewhere in between these two extremes and willing to take some risks?

HOW DO I KNOW WHICH EQUITY-INDEXED ANNUITY IS BEST FOR ME?

As with any other insurance product, you must carefully consider your own personal situation and how you feel about the choices available. No single annuity design may have all the features you want. It is important to understand the features and trade-offs available so you can choose the annuity that is right for you. Keep in mind that it may be misleading to compare one annuity to another unless you compare all the other features of each annuity. You must decide for yourself what combination of features makes the most sense for you. Also remember that it is not possible to predict the future behavior of an index.

QUESTIONS YOU SHOULD ASK YOUR AGENT OR THE COMPANY

See the main portion of this Buyer's Guide to Fixed Deferred Annuities for general questions that apply to annuities. The following questions are especially about equity-indexed annuities.

How long is the term?

What is the guaranteed minimum interest rate?

What is the participation rate? For how long is the participation rate guaranteed?

Is there a minimum participation rate?

~~What charges, if any, are deducted from my premium?~~

~~What charges, if any, are deducted from my contract value?~~

Does my contract have an interest rate cap? What is it?

Does my contract have an interest rate floor? What is it?

Is interest rate averaging used? How does it work?

Is interest compounded during a term?

Is there a margin, spread, or administrative fee? Is that in addition to or instead of a participation rate?

~~Which~~What indexing method is used in my contract?

What are the surrender charges or penalties if I want to end my contract early and take out all of my money?

Can I get a partial withdrawal without paying charges or losing interest? Does my contract have vesting? If so, what is the rate of vesting?

~~Does my annuity waive withdrawal charges if I am confined to a nursing home or diagnosed with a terminal illness?~~

~~What annuity income payment options do I have?~~

~~What is the death benefit?~~

Final Points to Consider

Remember to read your annuity contract carefully when you receive it. Ask your agent or insurance company to explain anything you don't understand. If you have a specific complaint or can't get answers you need from the agent or company, contact your state insurance department.

ATTACHMENT THREE-B

ANNUITY DISCLOSURE MODEL REGULATION

Draft: June 23, 1998

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Section 1. Purpose

The purpose of this regulation is to provide standards for the disclosure of certain minimum information about annuity contracts to protect consumers and foster consumer education. The regulation specifies the minimum information which must be disclosed and the method for disclosing it in connection with the sale of annuity contracts. The goal of this regulation is to ensure that purchasers of annuity contracts understand certain basic features of annuity contracts. Insurers shall define terms used in the disclosure statement in language that facilitates the understanding by a typical person within the segment of the public to which the disclosure statement is directed.

Section 2. Authority

This regulation is issued based upon the authority granted the commissioner under Section [cite any enabling legislation and state law corresponding to Section 4 of the NAIC Unfair Trade Practices Act].

Section 3. Applicability and Scope

This regulation applies to all group and individual annuity contracts and certificates except:

- A. Registered or non-registered variable annuities or other registered products;
- B. Immediate and deferred annuities that contain no nonguaranteed elements if the contract describing the benefits is provided at time of application or if it is provided at time of delivery and a thirty-day free-look is provided;
- C. (1) Annuities used to fund:
 - (a) An employee pension plan which is covered by the Employee Retirement Income Security Act (ERISA);
 - (b) A plan described by Sections 401(a), 401(k), 403(b) of the Internal Revenue Code, where the plan, for purposes of ERISA, is established or maintained by an employer,
 - (c) A governmental or church plan defined in Section 414 or a deferred compensation plan of a state or local government or tax exempt organization under Section 457 of the Internal Revenue Code; or
 - (d) A nonqualified deferred compensation arrangement established or maintained by an employer or plan sponsor.
- (2) Notwithstanding Paragraph (1), the regulation shall apply to annuities used to fund a plan or arrangement that is funded solely by contributions an employee elects to make whether on a pre-tax or after-tax basis, and where the insurance company has been notified that plan participants may choose from among two (2) or more fixed annuity providers and there is a direct solicitation of an individual employee by a producer for the purchase of an annuity contract. As used in this subsection, direct solicitation shall not include any meeting held by a producer solely for the purpose of educating or enrolling employees in the plan or arrangement;
- D. Structured settlement annuities; and
- E. Charitable gift annuities.

Section 4. Definitions

For the purposes of this regulation:

- A. "Contract premium" means the gross premium that is required to be paid under a fixed premium contract, including the premium for a rider for which benefits are shown in the illustration.
- B. "Contract owner" means the owner named in the annuity contract or certificate holder in the case of a group annuity contract.
- C. "Generic name" means a short title descriptive of the annuity contract being applied for or illustrated such as "single premium deferred annuity."
- D. "Guaranteed elements" means the benefits, values, credits and charges under an annuity contract that are guaranteed and determined at issue.
- E. "Non-guaranteed elements" means the benefits, values, credits and charges under an annuity contract that are not guaranteed or not determined at issue.
- F. "Premium outlay" means the amount of premium to be actually paid or assumed to be paid by the contract owner or other premium payer out-of-pocket.

Section 5. Standards for the Disclosure Document

- A. An applicant for an annuity contract shall be given both a disclosure document as described in Subsection B and the Buyer's Guide contained in Appendix A as early in the sales process as practicable. The company will make every reasonable effort, both locally and globally, to distribute the Buyer's Guide prior to the sales process. The disclosure document shall be provided at the time of application or, in the case of a sale conducted by means of the telephone, mailed to the applicant within two (2) business days. If the insurer elects to deliver the Buyer's Guide only at the time of contract delivery, an additional period of ten (10) days shall be added to any otherwise applicable right of return period for the owner to review the contract and Buyer's Guide. If, however, the insurer makes reasonable efforts to assure that the Buyer's Guide is made available to prospective applicants, preferably before, but no later than the time of application, no additional review period shall be required.

Note: An insurer may demonstrate it has made reasonable efforts by:

1. Working with regulators in its state of domicile to present public service announcements regarding the availability of the Buyer's Guide;
2. Encouraging its producers to use the Buyer's Guide in mailings to or in seminars for potential purchasers or in other communications with clients;

3. Including in any newsletters sent to contract owners an announcement of the availability of the Buyer's Guide; or
4. Including the Buyer's Guide on its Web-site and encouraging individual representatives or other intermediaries to do the same;

and other similar efforts.

B. At a minimum, the following information shall be included in the disclosure document required to be provided under this regulation:

- (1) The generic name of the contract, the company product name, if different, and form number, and the fact that it is an annuity;
- (2) The insurer's name and address;
- (3) A description of the contract and its benefits, emphasizing its long-term nature and describing in plain language, including examples where appropriate:
 - (a) The guaranteed and non-guaranteed elements of the contract, and their limitations, if any, and an explanation of how they operate;
 - (b) An explanation of the initial crediting rate, specifying any bonus or introductory portion, the duration of the rate and the fact that rates may change from time to time and are not guaranteed;
 - (c) Periodic income options both on a guaranteed and non-guaranteed basis;
 - (d) Any value reductions caused by withdrawals from or surrender of the contract;
 - (e) How values in the contract can be accessed;
 - (f) The death benefit, if available and how it will be calculated;
 - (g) A summary of the federal tax status of the contract and any penalties applicable on withdrawal of values from the contract; and
 - (h) Impact of any rider, such as a long-term care rider.
- (4) Specific dollar amount or percentage charges and fees shall be listed with an explanation of how they apply.
- (5) Information about the current guaranteed rate for new policies that contains a clear notice that the rate is subject to change.

C. All disclosure and marketing material shall be written using plain language with the negatives and positives of all features and concepts clearly presented.

D. Any concepts that are not specified in the requirements in Section B for the disclosure document that are included in the contract or offered with the contract by the company shall be included and clearly explained in the disclosure document.

Section 6. Annual Report; Notice to Contract Owners

The insurer shall provide each contract owner with an annual report on the status of the contract that shall contain at least the following information:

- A. The beginning and end date of the current report period;
- B. The accumulation and cash surrender value at the end of the previous report period and at the end of the current report period;
- C. The total amounts that have been credited or charged to the contract value during the current report period; and
- D. The amount of outstanding loans, if any, as of the end of the current report period.

Section 7. Penalties

In addition to any other penalties provided by the laws of this state, an insurer or producer that violates a requirement of this regulation shall be guilty of a violation of Section [cite state's unfair trade practices act].

Section 8. Separability

If any provision of this regulation or its application to any person or circumstance is for any reason held to be invalid by any court of law, the remainder of the regulation and its application to other persons or circumstances shall not be affected.

Section 9. Effective Date

This regulation shall become effective [insert effective date] and shall apply to policies sold on or after the effective date.

ATTACHMENT THREE-C

Interim Report on Supportability Testing of the Disclosure Work Group of the Committee on State Life Insurance Issues June 1998

This report was prepared by the American Academy of Actuaries' Disclosure Work Group of the Committee on State Life Insurance Issues at the request of the NAIC Life Disclosure Working Group. Members of the Academy work group are:

| | |
|--|------------------------------------|
| Stephen J. Preston, FSA, MAAA, Co-Chair | John B. Dinius, FSA, MAAA |
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| Roger K. Wiard-Bauer, FSA, MAAA | |

With appreciation to the many interested parties for their active participation and contributions.

Executive Overview

As requested by the NAIC Life Disclosure Working Group (LDWG), the American Academy of Actuaries Disclosure Work Group (Academy DWG) has continued research into supportability tests for annuities that illustrate non-guaranteed elements. This report further develops the theoretical work summarized in the Academy DWG's February 1998 report.

The Academy task force is pleased to report having completed significant work in annuity supportability test development for use by the LDWG in its deliberations on supportability disclosure and testing options. This report focuses on three main areas:

- the identification of the key elements which impact the credited interest rate a company can support;
- the running of stochastic computer testing models to understand the sensitivities to each of these elements; and
- the development of several possible "bright line" tests which could adequately reflect the results of more sophisticated testing models in a simplified way.

In conducting its work, the Academy DWG used the Life Insurance Illustration Model Regulation for guidance on scope and purpose. However, the group realized that the risks inherent in annuities are not the primary risks in life products. Most notable differences deal with the risks centered around credited interest rates in annuities. Thus, it was known from the outset that the difference between life and annuity products meant that the specifics of the life test would likely be inappropriate for annuities, and that an entirely new test would need to be developed.

The Academy DWG believes that its work to date has served to focus its attention on several key matters which will shape the adoption of an effective disclosure and supportability framework. In order to advance the development of a concrete, final recommendation, the Academy work group now needs feedback from both regulators and industry on the methodologies outlined in this report.

Section-by-Section Overview of the Report

General Issues

The goal of the first section is to frame the general issues the reader will want to consider when reading the remainder of the report.

Appropriateness of the Asset/Liability Management

Asset/liability management is central to the Academy DWG's research. This section discusses why it should be reflected as part of an annuity supportability test. It also discusses how different goals were used in developing the supportability tests for the Life Insurance Illustration Regulation.

Benchmarking

Benchmarking uses rigorous modeling to identify which supportability assumptions are important. It also provides a standard of comparison for developing a simplified brightline test. The Academy DWG has run many different scenarios as part of the stochastic modeling used to develop these benchmarking results.

This section summarizes the extensive benchmarking work completed on three sample product designs: a single premium deferred annuity (SPDA), an Bonus SPDA and a two-tier SPDA. Initial observations show the importance of recognizing different pricing criteria, asset/liability management, and the crediting strategy for renewal interest rates.

Simplification Options for Assumptions

This section describes the various actuarial assumptions used in supportability testing, and the extent to which each assumption could be simplified to develop a bright line test.

Annuity Supportability Test Overview

This section discusses six major options for supportability testing. It begins with the most rigorous and complex test and then describes tests that simplify various assumptions. Included for each option is a description of the test, possible criteria for passing the test, and a brief discussion of the rigor and drawbacks of the test.

Multiple Test Alternative

There are competing needs for rigorous testing versus simplified testing. This section discusses the possibility of utilizing more than one test to balance these competing needs.

Supportability Disclosure

The Academy DWG continues to explore the potential of disclosure material as a complement to or substitute for supportability testing. The section on supportability disclosure describes yet another form of disclosure which would identify and discuss the risks faced by a purchaser of an individual annuity product. The Academy DWG will continue discussions on supportability disclosure and provide more information in its next report to the LDWG in September.

Next Steps

This section outlines the steps needed to develop more detailed recommendations on supportability testing. The Academy DWG strongly recommends that this report be widely exposed for comment (through LDWG minutes, NAIC Life and Health Actuarial (Technical) Task Force (LHATF) mailings, and mailings of the major life insurance associations.). Additionally, over the next several weeks, the Academy DWG will need to discuss its report with LDWG members in order to move the process forward.

Significant additional work will need to be completed by the Academy DWG in order to develop a more specific recommendation. This work will need to be consistent with the direction of the draft annuity disclosure model regulation. Additional time will then be required for further comment and for the development of an Actuarial Standard of Practice, if one is needed prior to promulgation of a model rule.

Appendices

The report includes two appendices. The first describes the product assumptions and specifications used in the benchmark testing whose results are described in section III. The second is a letter from the Academy DWG to the NAIC LDWG. The letter includes recommended definitions of guaranteed, determinable and non-guaranteed elements for possible use in the draft annuity disclosure model regulation.

Closing Comments

The Academy DWG is pleased to offer this interim report on its progress in researching annuity supportability testing options and supportability disclosure. We look forward to input on the general issues and to making more specific recommendations in September.

Please contact Barbara Lautzenheiser, Steve Preston or any other members of the Academy Disclosure Working Group with comments or questions. Feedback will be greatly appreciated.

I. General Issues

In developing an annuity supportability test, the Academy DWG is seeking guidance from regulators and input from the industry on a range of general issues important to the Academy DWG's development of recommendations. Presenting these early in the report is designed to help frame issues for consideration when reading the remainder of the report.

Readers are encouraged to contact the Academy DWG with questions and comments on these issues.

Key General Issues

1. **Asset and Liability Management** - Academy DWG analysis has repeatedly identified that the assets backing the policy form are a key (if not the key) to annuity supportability. This is a significant shift from how the Life Insurance Illustration Regulation viewed supportability testing.

The Academy DWG research assumes asset and liability matching should be reflected in a supportability test.

2. **Cost of Capital** - Benchmark testing has shown that a key to annuity supportability is reflecting the cost of capital (which was reflected in the form of benchmark profit requirements). This is a significant change from how the Life Insurance Illustration Regulation tests were designed. The Academy DWG recognizes the sensitivity of this issue and has designed its research to be consistent with the historic practice of not regulating profit margins.

The Academy DWG is exploring approaches that allow a company to reflect its own cost of capital.

3. **Balancing Complex and Rigorous Testing with Simplified Testing** - Academy DWG research clearly shows that complex and rigorous testing methods can demonstrate that variations in illustrated rates are appropriate. Such tests may be desirable from a theoretical point of view, and some regulators and members of industry may feel most comfortable with such a test. However, such methods depend on the quality of the assumptions and may be difficult to verify. They may also be too expensive and time-consuming to complete frequently.

Others may prefer a simplified test. Such a test could be easier to perform and easier for regulators to verify. Simplification could be accomplished by eliminating or standardizing assumptions and methodology. The Academy DWG research to date shows that assumptions for annuities are highly interrelated. Simplification is thus more likely to result in less accurate results. Regulators may have concerns about consumer protection. Companies may have concerns about losing the ability to distinguish their products in the marketplace.

The Academy DWG continues to explore issues relating to the balance of rigor and simplicity.

4. **Coordination with Other Regulatory Requirements** - An annuity supportability test can demonstrate sufficiency on a stand alone basis or such testing can rely in part on other regulations (e.g., asset adequacy requirements).

The Academy DWG research has identified when supportability testing can stand alone and when it can complement existing regulatory requirements.

5. **Supportability Disclosure** - The Academy DWG will continue to explore consumer disclosure of supportability which could be important to help consumers better understand non-guaranteed elements.

The Academy work group believes that there are several goals of annuity disclosure that the LDWG would like to address with annuity supportability testing. These include addressing the issues of intent to pay, the ability to pay, and ability to prevent the potential to mislead a customer.

As discussed in the work group's February report, all supportability tests identified thus far have limited ability to address the intent-to-pay goal. As with the Life Sales Illustration Model Regulation and Actuarial Standard of Practice, the intent to pay cannot be easily measured. Supportability disclosure, although also limited, provides the best opportunity to address the intent-to-pay goal. Therefore, supportability disclosure could be considered a complement to, or a substitute for, supportability testing to satisfy this goal. Since the elements being illustrated are non-guaranteed, it is possible for a company at a later date to reduce its credited rates to earn a higher spread than originally illustrated, for example. As was accepted with the Life Sales Illustration, even if a company intends to pay the renewal rates it illustrates, market conditions may deteriorate so that it cannot earn the rates expected at issue. The ability to pay such high rates may no longer be there, although that could not have been anticipated at time of illustration. In short, passing a particular test cannot guarantee that a customer will not be misled.

As the LDWG continues to develop the annuity disclosure model regulation, the Academy DWG also may need to explore further the use of disclosure to the consumer on supportability of non-guaranteed elements.

6. **Future Innovative Products** - The Academy DWG believes supportability testing should consider and plan for the development of new products in the future. Along these lines, the group has developed definitions to assist in incorporating equity-indexed products into the model regulation. As the model continues to develop, continued consideration needs to be given to how the future product innovations can be accommodated.

II. Appropriateness of Asset/Liability Management

In developing the Life Insurance Illustration Regulation, the major focus appeared to be on the concerns raised by vanishing premiums and the use of projected future improvements in experience, and on helping the consumer understand how expenses, mortality charges and interest interact. Regulatory concern also focused on preventing the illustration of lapse supported benefits. Essentially, the life tests focused on expense risk, mortality risk, anti-selection risks, and lapse supported risks.

For annuities in the deferral period, the credited interest rate is a central product feature in the eyes of the consumer. Thus, unlike the life tests, the major focus of annuity tests should be on the risks associated with poor asset/liability management, which results in interest rate risks to the consumer.

Interest Rate Risks

There are three main interest rate risks: disintermediation, hedging risk, and credit risk. Disintermediation is the risk of an increase in assumed lapse rates following an increase in interest rates, and the resulting market value loss when assets are sold. The level of surrender charges can affect this risk. Hedging risks occur when a company invests too long, too short, or otherwise inappropriately for its liabilities and fails to buy appropriate hedging investment instruments to limit these risks. Credit risks involve investments that deteriorate or default, affecting the ability to earn (and thus pass on to a customer) an appropriate interest rate. Credit deterioration can also increase capital costs due to increased risk-based capital (RBC) costs. In addition, the RBC factors increase as surrender charges wear off.

Other Asset/Liability Concerns

Appropriate asset/liability management would take into account various items. As one example, the presence of a surrender charge would affect the risk of disintermediation, since a rise in interest rates would more likely cause a customer to lapse if surrender charges had worn off than if surrender charges were still high. After the surrender charges wear off, the increased likelihood of lapse would indicate that shorter investments would be more appropriate, which would generally decrease the earned rate on reinvestments. As time passes, defaults will be more likely for a particular investment. In addition, the RBC factors increase as surrender charges wear off, thus increasing the cost of capital.

Differences in the Nature of Life and Annuity Risks

The major risks that were addressed by the life lapse support and self-support tests do not have the same critical impact on annuities. Mortality and anti-selection risks are minimal during the accumulation period. Expense risks also do not have as much impact as the interest-related risks mentioned above. Much of the lapse risk for annuities is found in the disintermediation risk mentioned above. However, there can be additional lapse risk if lapses were lower than expected for products which pay higher benefit levels in later years (e.g., products with high long-term annuitization benefits).

The simple extension of the life illustration regulation to annuity products would not adequately address the greater sensitivity of annuity illustrations to interest rate variations. For example, the use of recent historical experience (as defined in the life illustration regulation) is inconsistent with the need to base annuity pricing on the precise conditions obtaining at the time of the sale, and the need to reflect an investment mix appropriate to the particular product being priced. There is also a concern that a life-type test could reward the insurer that took large interest rate risks of the types mentioned above and could provide an incentive to manage those risks poorly.

Closing Comment

The Academy DWG's overall conclusion is that annuity supportability tests should focus on the above interest rate risks and should determine that appropriate asset/liability management techniques have been employed.

III. Benchmarking

Benchmarking is the process of determining the effectiveness of a simplified, or brightline, supportability test by comparing results with a more sophisticated, or benchmark, test. Benchmarking provides increased assurance that the message conveyed from the result of a brightline test is correct and would be supported by more advanced testing methods. It is the validity check on a simplified testing method.

In order to be credible, a benchmark test should reflect the current state of generally accepted actuarial practice. It should encompass all relevant scenarios and assumptions which an actuary would consider in performing a rigorous supportability test. Properly constructed, a benchmark test can assist in the design of a bright line test. It can test the sensitivity of results to variations in assumptions, eliminating the need to include in a bright line test those factors for which results are relatively insensitive.

During the last several months, the Academy DWG has completed significant benchmarking work for use in the development, and justification, of a bright line test for the supportability of annuity illustrations. This work is not meant to be an exhaustive study of all the financial factors which impact annuities, nor a demonstration of state-of-the-art modeling techniques. Instead, it is an illustrative exercise to show how even a relatively straightforward benchmarking model can provide points of comparison for more simplified tests and help isolate those factors that seem most important to include in simpler tests.

Benchmark Modeling Description

Benchmarking models have been run for three common types of single premium deferred annuity contracts:

- (i) a "plain" SPDA with annual interest rate resets,
- (ii) a "bonus" SPDA with a 3% rate enhancement in the first policy year, and
- (iii) a "two-tier" annuity in which the upper tier is credited an interest rate higher than the cash value rate for the first ten years (4% higher in years 1-5, 2% higher in years 6-10). The two-tier results are included only where they lend additional insight beyond what the plain and bonus products provide.

The benchmarking models assumed simple investment strategies using combinations of 2, 5, 7 and 10 year A-rated public bonds. They were run more than 100 stochastically generated interest rate scenarios starting from each of three initial yield curve assumptions. Benchmark assumptions for all relevant factors (e.g., lapsation, mortality, expenses) were included. Benchmarking assumptions and specifications are shown in Appendix A.

The objective of this exercise was to determine the maximum credited interest rate which could be supported, and hence illustrated, based on two minimum benchmark testing profit criteria for the average of the scenarios: i) discounted earnings equal to zero using a discount rate equal to the five-year Treasury rate and ii) discounted earnings equal to zero using a discount rate equal to 200% of the five-year Treasury rate.

Investment strategies were adjusted to maximize the credited rate, subject to the benchmark testing profit criteria. An arbitrary solvency criterion, positive cumulative benchmark testing profits in 85% of the scenarios tested, was assumed to be an additional requirement.

Results

The results of these tests lend insight into the critical factors impacting supportable credited rates. The tables below provide a selection of the credited interest rates supportable under different combinations of assumptions. Because the benchmark model is itself simplified, the absolute level of the numbers should be considered as approximate, though the relationship between any two supportable credited rates is credible enough to draw some initial conclusions.

Benchmark Testing Profit Criteria

For example, consider the range of results (maximum supportable credited rates) under the two different benchmark testing profit criteria. The table compares results under two different yield curve assumptions. The products adopt an asset mix which maximizes the credited rate while predicting solvency in at least 85% of the scenarios tested.¹

| Maximum Supportable Credited Rates | | | |
|---------------------------------------|----------------|------------|-------------------------|
| Sensitivity to Profit Criteria | | | |
| Profit Criteria | Yield Curve | Plain SPDA | Bonus SPDA ² |
| Discount rate = 5-yr treasury | Dec-97 (flat) | 5.37% | 4.85% |
| Discount rate = 200% of 5-yr treasury | Dec-97 (flat) | 4.93% | 4.31% |
| Difference | | 0.44% | 0.54% |
| Discount rate = 5-yr treasury | Dec-92 (steep) | 5.98% | 5.72% |
| Discount rate = 200% of 5-yr treasury | Dec-92 (steep) | 5.74% | 5.16% |
| Difference | | 0.24% | 0.56% |

¹ For the bonus SPDA product an 80% profit criterion was used.

² Renewal rate is shown.

As might be expected, a substantially higher credited interest rate was supportable under the lower benchmark testing profit criteria than the interest rate supportable using the higher benchmark testing profit criteria. The effect is more pronounced under the bonus SPDA product, but observable in the plain product as well. The two-tier annuity would likely produce similar results.

Though not uniformly observed, the 85% solvency criterion affects the results too, by eliminating asset strategies which would produce unacceptably volatile results. For example, in the absence of this 85% constraint, the plain SPDA rate using the 1992 curve and the five-year treasury discount rate would be 6.18% instead of 5.98%. This constraint forces more rational asset-liability management on the asset selection process, to reduce volatility.

The key conclusion is that the level of credited rate supportable is sensitive to the benchmark testing profit criteria imposed on the product.

Asset Mix and Yield Curve

Another result demonstrated by the benchmark testing is the impact on the supportability of credited interest rates of the matching of an initial asset strategy to the product liability cash flows. The following table displays the maximum credited

rates supportable for various asset mixes and a present value of profit objective of zero under the average of 100 stochastically generated interest rate scenarios, with the five-year Treasury rate used for discounting.

| Maximum Supportable Credited Rates Sensitivity to Asset Mix and Yield Curve | | | | | |
|--|----------------|------------|---------|-------------------------|---------|
| Asset Strategy 2yr/5yr/7yr/10yr | Yield Curve | Plain SPDA | | Bonus SPDA ¹ | |
| | | Cred. Rate | Solv. % | Cred. Rate | Solv. % |
| 25/50/25/0 | Dec-97 (flat) | 5.34% | 86% | 4.85% | 85% |
| 0/0/50/50 | Dec-97 (flat) | 5.35% | 80% | 4.86% | 79% |
| 25/50/25/0 | Dec-92 (steep) | 5.35% | 85% | 4.84% | 79% |
| 0/0/50/50 | Dec-92 (steep) | 6.18% | 80% | 5.72% | 80% |
| 25/50/25/0 | Avg + 3% (med) | 8.14% | 81% | 7.60% | <75% |
| 0/0/50/50 | Avg + 3% (med) | 8.27% | 77% | 7.92% | 77% |

¹ Renewal rate is shown

In this chart, "Asset Strategy" refers to the initial mix of A-rated bonds of the indicated lengths, "Solv. %" refers to the percent of tested interest rate scenarios for which positive cumulative surplus is observed at the end of the projection period, and "Avg + 3% (med)" refers to an initial yield curve approximately equal to the December 1997 curve shifted up by roughly 3% at all durations, and rotated to give a somewhat steeper shape.

The results validate the obvious conclusion that higher credited rates can be supported by selecting an optimal asset mix, subject to an appropriate level of asset/liability matching. Under a flat yield curve, this observation is unremarkable, as lengthening the asset portfolio adds virtually nothing to the credited rate while adding a measurable increase in volatility, as evidenced by the reduced number of scenarios passing the solvency test.

Under steeper yield curves, however, the impact is more dramatic. The supportable credited rates increase by more than 0.80% by lengthening the initial asset strategy in the steep yield curve environment, with only a modest (and sometimes non-existent) increase in volatility.

For the products tested thus far, this might lead to the belief that the highest supportable rate can be credited by investing at the points along the yield curve where interest rates are highest. However, the increase in volatility, demonstrated by the solvency percentage, needs to be considered. It is an indication of the increased interest rate (C-3) risk assumed in pushing for the maximum yield. Recall, in the example above, that strengthening the solvency requirement from 80% to 85% of the tested scenarios reduced the supportable credited rate for the plain SPDA by 0.20%.

Further testing may be needed on products and asset strategies with even greater mismatch potential to show how imposition of an 85% solvency requirement could reduce the credited rates otherwise supportable. Testing would continue to demonstrate the importance of proper asset/liability management in justifying the supportability of credited rates, and would support the notion — a central thesis of this report — that some measure of asset/liability matching is a desirable element of any supportability test.

| Maximum Supportable Credited Rates Sensitivity to Crediting Strategy and Yield Curve | | | |
|---|----------------|---------------|------------------|
| Crediting Strategy | Yield Curve | Credited Rate | Solvency Percent |
| Base | Dec-97 (flat) | 5.37% | 85 |
| Reduce | Dec-97 (flat) | 5.99% | <75 |
| Base | Dec-92 (steep) | 5.98% | 84 |
| Reduce | Dec-92 (steep) | 7.14% | <75 |

Sensitivity to Crediting Strategy and Yield Curve

Another interesting observation is the role which the interest crediting strategy plays in the demonstration of supportability. The following table compares results under two crediting strategies, a "base" strategy where credited rates are driven solely by the performance of the underlying asset portfolio and a "reduce" strategy, where the initial credited rate is enhanced by setting the renewal rate to be the lesser of the earned rate minus the pricing spread and the rate a "competitor would credit" (assumed to be the five-year Treasury rate) on new business. The table below considers the plain SPDA contract, and the five-year treasury discount rate in the profitability criteria.

As might be expected, the "reduce" strategy produces a considerably higher initial credited rate, supported by the reduced interest rates which will be credited in renewal years under the scenarios where new business interest rates decline. However, the strategy generates much greater risk as well, since many "up" scenarios result in insolvency. This is reflected in the reduced solvency percentage.

Forcing the "reduce" strategy to meet the 85% solvency criterion produces a more supportable result. The supportable rate under the December 1997 yield curve drops from 5.99% to 5.53%, still higher than, but considerably closer to, the 5.37% rate supportable under the base strategy. This could suggest that the 85% solvency criterion puts significant discipline on the crediting strategy to keep companies that pursue aggressive strategies from illustrating rates appreciably higher than their more conservative counterparts.

While the testing so far has been limited, the results to date, at the very least, should demonstrate the usefulness of what here is referred to as the "solvency percent" in the benchmark testing profit criteria, to reflect the quality of asset-liability management in the supportability test of an illustrated rate.

Sensitivity to Lapse Rates

Finally, testing of various lapse rates suggested a modest level of sensitivity of credited rates to lapsation. Again, the five-year Treasury discount rate in the benchmark testing profitability criteria and the "25/50/25/0" asset strategy (see table above) were assumed. All other assumptions were kept constant.

"Base" lapse assumptions grade to 5% in year 4, remain at 5% until year 7, jump to 30% in year 8 (the year the surrender charge schedule expires) and revert to 15% per year in year 9 and thereafter. "Base plus dynamic excess" introduces lapse sensitivity to interest rate scenarios by increasing the lapses as the credited interest rate under the contract drops below the new money rate available in the marketplace, subject to a 40% maximum lapse rate. "150% Base plus dynamic excess" uses the same dynamic mechanism applied to base lapse assumptions which have been increased by 50%. For the two-tier product, the lapse percentages include cash surrenders as well as annuitizations.

The following credited rates were found to be supportable under various lapse assumptions.

| Maximum Supportable Credited Rates Sensitivity to Lapse Rates | | | | |
|---|----------------|------------|-------------------------|--------------------------|
| Lapse Assumption | Yield Curve | Plain SPDA | Bonus SPDA ¹ | 2-Tier SPDA ² |
| Base | Dec-97 (flat) | 5.50% | 5.18% | 5.50% |
| Base plus dynamic excess | Dec-97 (flat) | 5.34% | 4.85% | 5.44% |
| 150% Base plus dyn excess | Dec-97 (flat) | 5.26% | 4.72% | 5.28% |
| 0% surr, dyn annuitization | Dec 97 (flat) | — | — | 5.10% |
| Base | Dec-92 (steep) | 5.57% | 5.25% | 5.60% |
| Base plus dynamic excess | Dec-92 (steep) | 5.35% | 4.84% | 5.50% |
| 150% Base plus dyn excess | Dec-92 (steep) | 5.27% | 4.72% | 5.32% |
| 0% surr, dyn annuitization | Dec-92 (steep) | — | — | 5.16% |
| ¹ Renewal rate is shown. | | | | |
| ² Ultimate renewal rate for both tiers is shown. See Appendix A for details. | | | | |

Thus far, the results show that credited rates vary somewhat by lapse assumption for the plain and two-tier SPDA products and slightly more for the bonus product. Solvency percentages generally exceed 85% for all assumptions illustrated in the table, with the highest percentages (least volatility) associated with the unadjusted base assumptions.

Additional testing was completed for two-tier annuitizations on sensitivity to lapse experience. For example, retesting the two-tier product with base lapse rates (cash surrender rates) of zero and dynamic excess lapses results in maximum supportable credited rates of 5.10% under the December 1997 (flat) yield curve (vs. 5.50% under the base assumptions) and 5.16% under the December 1992 (steep) yield curve (vs. 5.60%).

The testing on lapse sensitivity so far has been performed on relatively well-designed products. The results serve to illustrate the role played by a properly designed surrender charge schedule to protect against anti-selection. Products with poorly designed surrender charge schedules, or heavy back-end benefits, would likely show greater sensitivity to surrender or annuitization experience.

Closing Comments

The Benchmarking process has been valuable for both gaining insight into the modeling process as well as understanding the interdependency of assumptions. The results of the models will serve as a standard against which the quality of simplification methods will be measured.

IV. Simplification Options for Assumptions

Developing a simplified "bright line" test for annuity supportability is challenging. It involves replacing assumptions and methods that are "complex" with "approximate" or "standardized" factors.

To assist in its research, the work group reviewed a list of assumptions to see 1) which could be excluded entirely from brightline testing or included in an obvious way without further research and 2) which required more research in light of the need for balance between simplicity and accuracy.

The results indicate that the assumptions are interrelated and that each is important in setting the final illustrated interest rate. It is difficult to identify discrete assumptions to simplify that won't have a significant impact on the other assumptions.

Review of Assumptions and Simplification Options

1. General

A combination of actuarial judgment and standardized assumptions will likely be needed in any supportability test. Even at the simple end of the spectrum, actuarial judgment is required to set the product assumptions.

2.&3. Use of Scenarios and Asset/Liability Management

The use of multiple interest rate scenarios is generally accepted actuarial practice for demonstrating asset/liability management. As such, these need to be considered together.

If a test has an explicit recognition of asset/liability management, then it should be sufficient to complete only a deterministic scenario. If a test assumes that assets are matched to liabilities (e.g., an implicit recognition), then a test might include an up and a down interest rate scenario. A more complex test might include stochastically generated interest rate scenarios, or a limited set of scenarios such as the New York Seven.

Asset/liability management will need to be defined for illustration purposes. From a practical point of view, if completing annuity supportability testing is to be "routine," it will be important to facilitate testing by requiring only a limited number of interest rate scenarios. Conceivably, one choice might be to define a secondary type of test, performed annually, to demonstrate matching.

The use of scenarios and asset/liability management in a supportability test will involve a decision on the balance between rigor and simplicity. The Academy DWG will continue to explore the implications of such a decision.

4. Asset Strategy

In general, the life test permits all current industry asset strategies. The life test does not include requirements on any asset strategy or any interest allocation strategy. There are no requirements on asset/liability management.

For annuities, the Academy DWG believes that the asset strategy (and resultant investment return and risk) is one of the most important factors. Without modification, the work group believes that the life approach is not appropriate for annuities.

There are a variety of options when developing an annuity test. The asset strategy could be simplified or even standardized for a simple test. Such a standardized investment strategy would prohibit recognition of superior investment performance by those companies that can get such performance. More complex testing could recognize the actual asset strategy used by a company. This could result in demonstrating the supportability of appropriately higher interest rates.

There are key issues related to the consistent allocation of assets or investment returns to a particular block or product type. The Academy DWG will be continuing discussions on this point.

5. Interest Crediting Strategy

Differences between the initial interest rate and the renewal interest rate present a challenge to developing a simplified annuity supportability test. Based on our research to date, there can be a significant impact on the initial supportable credited rate due to differences in renewal interest rate crediting strategies.

However, it may be possible to simplify or standardize the renewal credited interest rate strategy.

One possible simplification would be to create a test that assumes a level crediting approach. For "non-level" crediting approaches, the test would allow the company to demonstrate how interest rate trade-offs satisfy the requirements. For example, a first year bonus of 100 basis points might require a 20 basis point reduction in overall credited rates. Guidance for demonstrating the trade-off equivalence could be provided through an Actuarial Standard of Practice.

One of the important goals here is to provide enough flexibility to cover as many products as possible in a simple test.

6. Capital Needs and Cost of Capital

For simpler approaches, more standardization is needed. Some approaches may make implicit assumptions about capital needs and cost of capital, and may or may not make changes to reflect assumed changes in company needs as a product matures. A simple test that uses a standardized asset strategy would likely also use a standardized capital assumption.

With a more complex test, as the need for accuracy increases, company and product specific capital requirements should be considered. For example, if a test uses the actual company yield on assets, some provision should be provided for cost of capital that reflects risks associated with the specific asset strategy. In this type of complex test, the capital assumptions would rely on actuarial judgment and could be subject to an Actuarial Standard of Practice.

7. Benefit Utilization

Lapses could be standardized in a simpler test, but companies should be able to reflect their own experience in the more complex testing. Standardized lapse assumptions would likely need to include the stress points discussed in the Academy DWG's February 1998 report to cover high early cash values, surrenders at the termination of the surrender charge, and high persistency to get high later year values. More research would be required on the base lapse rates in order to develop standardized rates for a simpler test.

Partial withdrawals should be included in the test, perhaps using company experience. For example, some companies offer partial withdrawal provisions that permit some percent of account value to be withdrawn free of surrender charge each year.

Annuity payments will become more important over time. Our current testing has mostly considered the accumulation phase of SPDA products. Some work has started on two-tier products, where annuity payments will be more important. Testing of annuity income illustrations (including no cash value products) will also need to focus on annuity payments. In actual practice, many companies provide annuity incomes based on current rates, which provides significantly greater benefits than those guaranteed under the contract. Test development should consider the supportability of these current rates as well as the utilization rate of annuity payments from deferred annuities.

Mortality. Thus far, to simplify work to date and because variations in mortality are believed to be less significant during the deferral stage, the Academy DWG has ignored mortality for the purposes of benchmark testing deferred annuity products. Mortality will need to be considered for annuity payments, SPIAs, and for products with substantial death benefits, as appropriate.

8. Expenses

Discussions considered whether an annuity supportability test should follow expense methodology used in the Life Insurance Illustration Regulation, including development of a generally recognized expense table (GRET) for annuities. The Society of Actuaries has had difficulties obtaining more detailed data sources to better refine the Life GRET. It is unknown if an annuity version of the GRET would face similar problems.

The issue of whether to use a GRET will be a decision to be made by the regulators with input from the SOA on the issues involved in developing such a table. Research on this can be completed at a future date, if needed.

Closing Comments

Our conclusion is that these assumptions are interrelated in ways that make it difficult to identify discrete assumptions to simplify. Key to simplification is the need for balancing simplicity and accuracy.

V. Annuity Supportability Test Overview

Listed below are six possible types of supportability tests. They have been arranged from most rigorous to most simplified to describe how simplification or standardization of various components leads to different types of tests.

Stochastic Method

Description

The Stochastic Method applies the full rigor of cash flow testing and asset/liability management to illustrated benefits. It uses many runs of different interest rate environments after issue to "stress test" a product and its supporting assets.

The Stochastic Method has a strong reliance on actuarial judgment to set all key factors and their sensitivity to a dynamic interest rate. Factors include lapses, assets, earned and credited interest rates, risk-based capital, the cost of capital, expenses, FIT, etc. An annuity version of a generally recognized expense table could also be developed. The Stochastic Method also requires identifying a strategy for determining renewal credited interest rates as changes occur after issue in future market interest rates.

Criteria for Passing

Criteria for passing the Stochastic Method require both meeting some type of solvency criteria (set in the regulation) and pricing criteria (set by each company and which may vary each by company). Suggestions for passing criteria would need to be developed by the Academy DWG to assist the regulators in making their final decisions.

Rigor

By considering one product at a time, the Stochastic Method is very complete from an actuarial perspective. It addresses solvency testing and persistency issues. It looks at all factors from the unique position of the company selling the product.

Drawbacks

The Stochastic Method relies on subjective actuarial assumptions, including how a company will react to different interest rate environments. Also, this method is even stricter than the asset adequacy testing completed by Valuation Actuaries. It does not allow sufficiencies from one product to offset possible deficiencies in a different product. It tests only the one product and does not identify any other business risks that face the company. It also requires the most time to set assumptions and complete testing when new illustrated scales must be reviewed. Test results are only as valid as the actuarial assumptions used in the testing.

While the stochastic method is the most complete testing available, it is also expensive, complicated and difficult to verify. It is likely too difficult to be completed for frequent interest rate changes. For example, some companies change interest rates weekly and stochastic testing requirements would be impossible to implement.

Defined Scenario Stochastic Method

Description

The Regulation could define a limited number of future interest rate scenarios to be tested using the Stochastic Method described above. Again, company and product specific assumptions for lapses, expenses, would be used, although an annuity generally recognized expense table could be developed.

This concept is similar to the use of the New York 7 scenarios in valuation actuary cash flow testing. Specific scenarios would need to be identified for annuity supportability testing.

Criteria for Passing

The scenarios and the associated passing criteria would need to be developed.

Rigor

This may have rigor similar to the full stochastic method, but with the caveat that the method is applied to a well-defined set of interest rate scenarios.

Drawbacks

The drawbacks from the full Stochastic Method also apply here. It would still take a significant amount of time to set assumptions. With a defined (and limited) set of scenarios to test, computer run time would be somewhat reduced. Test results are still only as valid as the actuarial assumptions set, and the process is still expensive, complicated and hard to verify. Frequent interest rate changes would still be an issue for completing tests using this supportability test method.

Static Scenario Method - Product Based

This report describes two different static scenario methods. The product based approach bases key assumption on the company and product characteristics. The standardized approach, discussed later, uses some standardized factors for key assumptions.

Description

This is similar to the Life Insurance Illustration Regulation self-support and lapse-support tests. A traditional actuarial calculation (accumulated cash flow or asset share) is completed based on a static interest rate environment.

The annuity version, however, would need to consider additional components not found in the Life tests. Annuities need to consider factors associated with a decreasing surrender charge. These factors include a decrease in gross interest rates due to the shortening of investments to maintain asset liability matching and also the capital costs associated with risk-based capital needs. Other factors could be similar to the life self-support test - e.g., persistency, expenses with possible use of a generally recognized expense table, FIT, premium taxes, etc.

For asset liability management, the company would need to perform additional calculations to identify the gross interest rate reductions due to the shortening of investments for the decreasing surrender charges. Since this is product specific, essentially stochastic type calculations would be needed. The results could be "re-used" as static factors for the product design (without having to be re-run every time a new credited interest rate is tested).

For the capital costs, two main steps need to be completed.

The first step is to identify risk-based capital needs. Four items would need to be considered. Three of the items are the premiums paid, the quality of assets backing the interest rate assumptions, and the level of surrender charges. They are used with the C-1, C-3 and C-4 components of risk-based capital (C-2 does not typically apply to annuities). The result is a product specific risk-based capital. The fourth item needed is the overall ratio of company surplus to company wide risk-based capital. This is applied to the product based risk-based capital to get the company determined level of surplus for the product being tested.

The second step for determining the cost of capital requires identifying a level of earnings higher than the earned interest rate, as appropriate. This is applied to the company determined level of surplus for the product being tested (from above) to determine the cost of capital (or contribution to surplus).

Additional persistency stress tests could also be developed for the Static Scenario Method, similar to how persistency is modified for the life lapse support test. Annuities could conceivably use a second test with higher persistency and maybe even a third test with lower persistency. Appropriate persistency modifications would need to be developed, taking into consideration the more strenuous requirements for capital costs already built into the annuity version of the test.

Criteria for Passing

This needs to be determined. Different criteria may be needed for the persistency stress tests.

Rigor

The Static Scenario Method is familiar to actuaries and is compatible with many pricing methods. It is simplified because only one interest environment is tested and because actuarial assumptions need not be set for stochastic interest rate scenarios (such as assumptions on the impact of post issue market interest rate variations on future lapses or renewal interest rates strategies).

For this test, a single option cost must be developed for items such as increased lapses and adverse market scenarios. Considering the variety of products and distribution channels, it would be very difficult to identify a single option cost for all situations.

Drawbacks

The asset/liability charges must still be calculated by the company, which could involve a significant amount of work (especially for smaller companies that do not perform cash flow testing). Also, early profits (or losses) from terminating policyholders are accumulated and affect the passing criteria in later years.

Finally, this cost of capital calculation may result in unanticipated variations in illustrated rates. For example, the proposed test may result in highly capitalized companies illustrating lower interest rates than companies with lower capitalization (all other items being equal).

Margin Approach

Description

The Margin Approach takes a number of major steps further in standardizing assumptions when compared to the Product Based version of the Static Scenario Method.

Asset liability charges are standardized and based on the level of surrender charges outstanding (similar to how risk-based capital currently handles the issue).

Also, asset shares are not used. The formula used calculates an annual margin (or spread) between the gross interest rate and the credited interest rate, with appropriate adjustments for any bonuses, expenses, and cost of capital charges (possibly based on the risk-based capital method described in the Static Scenario Method). Reserves, FIT, and DAC Tax items are all excluded from the calculations for simplicity.

Moving to an accumulation of the margin means that lapse rates are not part of the accumulation formula (they are only used for determining the earliest year in which a positive accumulation must be present). This is somewhat similar to assuming a 100% persistency assumption in the Static Scenario test.

Criteria for Passing

Starting with the year that a specified cumulative percent (e.g., 50%) of policies are projected to either have lapsed or received benefits, in that year and every future year, there must be a positive accumulated margin (including the margin from the benefit payout period from illustrated benefits).

Rigor

The Margin Approach limits itself only to factors involved in testing the illustrated interest rate. It relies on the other regulatory standards to determine if the company is being managed appropriately (including reserves, valuation actuary testing and risk-based capital measures). The Margin Approach standardizes areas that are difficult for actuaries to determine (e.g., asset/liability matching for changes in interest rates). In other areas, such as earned interest rates and risk-based capital, it still uses company specific factors that are easy to verify.

Also, by shifting to accumulating the margin, this approach seeks to focus attention on the key item usually used to manage a product—the margin or spread. Performing the accumulation of margin without lapses results in each tested year having to

"stand on its own." This means that each benefit or year tested meets the passing criteria on a stand alone basis and does not provide or receive subsidy from any other policy benefit or year.

Finally, the method may be simple enough to be completed in a spreadsheet by a non-actuary, once actuarial assumptions are provided. Because of the simple model and the ability to use non-actuarial resources, it may be possible for companies to complete testing more frequently than other more complex methods.

Drawbacks

Standardized assumptions do not fit all situations. Some actuaries feel the Margin Approach does not have as strong of a theoretical foundation as asset adequacy or asset share testing. It is different than approaches currently being used by pricing or valuation actuaries. Also, the test does not capture losses from early surrenders if cash values are too high. Also, if the regulation allows for tests to be completed by non-actuaries, actuarial professional standards may not apply and other regulatory controls may need to be developed.

Static Scenario Method - Standardized

Description

The Standardized Static Scenario Method is most similar to the Life Insurance Illustration Regulation self-support test. An asset share projection is performed using current experience assumptions, including the assumption of a static (i.e., unchanging) interest rate environment. The same type of items are included, such as expenses (possibly with a generally recognized expense table), FIT, persistency, etc.

The annuity version, however, differs from the life version in some respects. Differences would include extra charges for asset/liability risk and cost of capital as well as different criteria for passing the annuity version.

The asset/liability charge should reflect the expected cost of options embedded in the assets and/or liabilities. Specifying an standardized amount in the regulation is an alternative to using more accurate product specific evaluation of this cost for liabilities. The standardized amount could vary with classification of the liability into the "high," "medium" or "low" C-3 risk categories for risk-based-capital.

The cost of capital charge could be standardized at a conservatively low level. For example, the charge could be the difference between a return on capital objective (e.g., 10-year Treasury rate plus 2%) and the after-tax earned interest rate, multiplied by an amount of capital equal to a percentage (e.g., 100%) of Company Action Level risk-based-capital factors.

Criteria for Passing

For the break-even year, the annuity version could use a slight modification from the life test. This would more appropriately reflect the larger variation of annuity product designs and persistency variations.

The life self-support test requires a product break-even by year 15. Based on the usual life policy persistency of 6-10% annual terminations, at 15 years about 20-40% of the original policies persist.

The break-even year for annuities could be defined as the latest year with aggregate persistency above a specified level, e.g., 30%. This "expected persistency" method is consistent with the life self-support test while allowing for variations in annuity product designs and experience.

The annuity version should compare the asset share to the present value of the highest available illustrated benefit. This would make the test more specific to annuities where annuity benefits may be greater than cash values. (The current life test wording is usually thought of as requiring a cash value comparison, but the actual life regulation calls for "any other illustrated benefit amounts available at the policy owner's election" to be tested.)

"Stress tests" for persistency (e.g., no lapse after five years) could also be added. The break-even year for these tests could be the same as the year determined by the expected persistency method. Also, the annuity version would use a cost of capital charge. This effectively increases the underlying profit objective to be higher than break-even and should result in modifications to any stress tests to avoid too aggressive of requirements.

Rigor

The basic methodology is familiar to many actuaries and was adopted as part of the life insurance illustrations model regulation. The standardized asset/liability charge makes the calculations simpler than stochastic calculations. By using the expected persistency method, the criteria for passing reflects variations in product design and experience.

Drawbacks

If a standardized asset/liability charge is used instead of a company's own stochastically calculated charge, then the charge will not fully reflect a product's individual risk situation. (Using RBC criteria adds some product specificity, however.) Ideally, the required capital objectives could be inconsistent with those assumed by the company. However, these objectives may not be well

defined for a company and may be difficult to apply in a regulation, which is why the test utilizes standardized values. Using risk-based-capital factors in the cost of capital charge will introduce an element of extra charge for extra risk.

Fixed Asset Method (Treasury Approach)

Description

For the Fixed Asset Method, the asset base used for the illustration is standardized to be the treasury yield curve plus an additional margin identified in the regulation (the additional margin to be determined by thorough research by the Academy). The resulting yield is reduced for expenses.

Asset liability management is assumed to be satisfied by determining the appropriate investment horizon for the liabilities (illustrated values). This calculation is based on three specified interest rate scenarios. This investment horizon is then "matched" using the treasury yield curve plus an the regulatory specified additional margin. After deducting a margin (or spread) for expenses, the result is a standardized interest rate that can be illustrated.

While this method uses the specifics of the product design, company expenses, and persistency, it does not use any other company specific factors. As such, it serves to produce a standardized illustrated interest rate that is conservative. While the rate should be supportable, in actuality it may or may not be supportable for a specific company. This supportability test relies on other regulatory tools to identify problem companies (via reserve, risk-based capital or other methods).

Criteria for Passing

The test is passed if the interest rate illustrated is appropriate for standardized assets for the investment horizon.

Rigor

The test methodology includes the actual investment horizon appropriate for a product, but does not reflect asset/liability matching. It does not consider other factors that influence the credited rate a company can provide for a specific product. This includes the actual assets used by a company, the strategy for setting credited interest rates, and the influence other factors (such as increased lapses) that occur and affect credited rates. Because of simplification of the assets used in the test, there is a loss of rigor. The method does, however, produce a conservative, standardized illustrated interest rate that reflects differences based on the yield curve position for treasury interest rates and the level of company expenses.

Drawbacks

The standardized asset base means that the test results do not reflect the actual assets used by a company. This means that the extra value added by companies can not be illustrated for consumers. Nor can illustrations reflect the extra risks associated with items such as lower quality assets, incomplete asset/liability management, higher risk-based capital costs, or higher profits or contributions to surplus.

Also, calculating the investment horizon for a product design is not an easy task. However, once completed, it would not need to be calculated again for testing other illustrated interest rates for the product. The only part of the regulatory prescribed process that would need to be re-done would involve the "treasury plus margin" asset yield calculation.

Finally, the "additional margin" over Treasury rates would need to be reevaluated from time to time.

VI. Multiple Test Options

The Academy DWG discussed at length the balance between complex and rigorous testing and simplified testing, as described in the General Issues section of this report. In trying to develop a single annuity supportability test, the desire to accurately reflect different management practices leads to a more complex test. More complex tests are by their nature costly and impractical to perform on a frequent basis.

An Alternative - Multiple Test Options

One possible alternative could be to develop multiple test options for annuity illustrations. For example, test options could be layered, ranging from a simple, conservative test, to a more complex (stochastic) test. Theoretically, the maximum credited rate that can be illustrated would increase somewhat as the testing complexity increases, because the company would provide a more detailed demonstration of supportability in the more complex tests.

A company would perform the simplest test that results in an illustrated credited rate with which they are comfortable. The initial simplest test would standardize many of the assumptions and the method. The more complex tests would allow for more actuarial judgment in both assumptions and method.

Simplification would be at the expense of the company, not the consumer (i.e., simplification would not produce a higher supportable interest rate). To the extent that simplification poses a problem for a company, they could conceivably move up the complexity scale to the next specified test to get a more accurate result.

Advantages

The major advantage of this approach is that it allows for simplified testing for those companies with limited resources or very frequent rate changes. It also allows for recognition of areas in which a company may excel, if the company is willing to perform the more complex dynamic test. It might also be able to accommodate innovative product designs.

Disadvantages

The major disadvantage of the multiple test option approach is that multiple tests would need to be developed and written into regulation, may need significantly greater resources to develop and maintain, and potentially could require more, not less, testing for some companies with limited resources.

VII. Supportability Disclosure

The Academy DWG continues to explore potential forms of disclosure material as a complement to, or substitute, for supportability testing. This section contains yet another form of disclosure.

When purchasing an individual annuity product, it may be desirable to disclose the risks that could affect their future policy values. This disclosure could identify several categories of risks to consumers that should be considered. It should also be disclosed that guarantees that limit a consumer's risk will increase the company's risk.

Five types of consumer risks are discussed below. All may be reduced or eliminated by the effects of company guarantees. The company may also share some of the risk with consumers through changes in the credited interest rate or other non-guaranteed elements.

Environmental Risk

The external environmental risk is part of the overall financial and physical environment. It includes, for example, changes in market yield rates, prices of securities, levels of securities indices such as the S&P 500, asset default rates, and inflation as it may affect the expenses of all insurance companies.

Company Experience Risk

The company experience risk is specific to each company and may distinguish it from another company operating in a similar external environment. This includes, for example, the success of a company's investment strategy, the company's success at controlling expenses, and the levels of voluntary surrenders of its products. This last subject is given treatment as a separate category of risk, below.

Autonomous Company Action Risk

The autonomous company action risk is also specific to each company. Consider, for example, two companies with similar assets, similar stable asset performance, a similar annuity product, and similar expenses and policyholder experience. The two companies may choose to take different autonomous actions. One may raise its interest rate credited to policyholders, thereby lowering its profit margin. At the same time, the other may lower its credited rate, thereby raising its profit margin or contribution to surplus requirements. Similarly, one would get different changes in profit margin, if both companies lowered credited rates, but by different amounts.

Fellow Policyholder Action Risk

The fellow policyholder action risk may be a difficult concept for some customers to grasp. A policyholder may be affected by the actions of his or her fellow policyholders, because the actions of others affect a company's overall experience. The company may respond to this change in experience by changing non-guaranteed element credits or charges applicable to the class of policies that includes that first policyholder.

For example, consider a product with initial policy benefits and expenses that exceed revenues. Such a product design might have a high first year bonus credited rate with surrender charges that do not fully recover benefit and expense costs. Higher than expected lapse rates just after that initial period could cause the company to lower later credited rates to other policyholders to a level less than originally anticipated in the pricing, in order to adhere to initial profit goals.

A second example would be a product that is vulnerable to heavy voluntary terminations as surrender charges decrease or expire. The potential for heavy lapses may cause a company to invest in shorter maturity assets with lower yields than originally anticipated. This could lead to lower credited rates for all policyholders.

As a final example, consider a deferred annuity that is designed to provide high credited rates in later years or high monthly income rates upon annuitization. These later benefits may be funded by less generous benefits to early terminators. If voluntary surrender rates are lower than expected in early years, a company may respond in later years by decreasing credited rates or monthly annuitization rates to remaining policyholders.

Voluntary Policyholder Action Risk

Finally, the voluntary policyholder action risk includes a voluntary termination by a policyholder that operates to his or her own disadvantage. This might happen by terminating and taking out the cash value shortly before a significant decrease in surrender charges or a significant increase in the level of persistency bonuses or other benefits. It could also include a decision to withdraw all or part of the cash value in a policy or not make an extra, voluntary premium payment, when the policy is crediting relatively high interest rates in comparison to other comparable uses of the money.

Closing Comment

The risk summary discussed above is a starting point for further discussions about using disclosure to explain to consumers the supportability of non-guaranteed elements. Further discussions are recommended to overcome possible challenges to achieving adequate consumer understanding of what the various concepts mean to each individual as he or she decides to purchase an annuity.

VIII. Next Steps

Steps

The Academy Disclosure Work Group will work toward the following steps being completed, and recommendations presented at the September 1998 NAIC meeting in New York:

1. Expose Academy DWG report for comment through LDWG minutes, NAIC Life and Health Actuarial (Technical) Task Force mailings, etc.
2. Discuss the report with LDWG members over the next several weeks.
3. Based on feedback, narrow down the possible supportability approaches.
4. Based on feedback, expand benchmark testing to reflect other product designs of concern to regulators.
5. Develop specific instructions for supportability tests that will be recommended. This includes initial recommendations for all necessary standardized factors and criteria for passing.
6. Compare Benchmark Testing results with supportability tests that will be recommended.
7. Develop recommendations and write a report for September 1998 NAIC meeting in New York. This will include comments on the use of disclosure to enhance consumer understanding of supportability.
8. Present the report to the LDWG at New York NAIC meeting in September.

Making substantial progress in developing recommendations will depend, in part, upon the type of feedback the work group receives.

Time for Review by Regulators and Industry

Following presentation of the recommendations at the September NAIC meeting, the Academy DWG recommends an ample comment period be provided for the LDWG and industry to review the recommendations and consider the impact on consumers and the marketplace. Companies will need time to test their specific products and identify possible changes in proposed tests.

Time for the Possible Development of an Actuarial Standard of Practice

The Actuarial Standard Board and its Life Operating Committee are receiving information on the Academy's progress and have included in their work plans the possible development of an Actuarial Standard of Practice for annuity supportability testing.

Appendix A

Benchmarking Assumptions and Specifications

Specifications and Assumptions—Plain SPDA and Bonus SPDA

Plan: \$25,000 average premium issued to a male age 55; with maturity at age 75.
Annual interest rate reset. Minimum interest guarantee 3.0%. Death benefit is fund value. Bonus SPDA is same as SPDA, except the first-year credited rate is 3.0% larger than renewal crediting rates.

Surrender Charges: 7.0% in the first year, grading down linearly to 0.0% year 8.

Partial Withdrawals: None.

Annuityizations: None.

Commission and Acquisition Expense: 7.0% of premium.

Maintenance Expense: \$50 per policy, no inflation.

Mortality: 1983 IAM.

Base Lapse: 1%, 3%, 4%, 5% for years one through four, respectively,
30 % for years five through eight, and
15% for year nine and later years.

Dynamic Excess Lapse: $5 * (\text{INDEX} - \text{CR})^2$, where
INDEX = competitor rate - threshold,
Competitor rate = 6 month average of five-year Treasury,
Threshold = 1% years 1-7, 0% thereafter,
CR = credited rate, and
Maximum total lapse rate = 40%.

Statutory Reserve: Equals cash surrender value (at end of policy year, uses next day's value).

Required Capital: 4.0% of statutory reserves.

Federal Income Tax: 35% of statutory gains. No DAC tax.

Shareholder Dividends: None.

Specifications and Assumptions—Two-tiered SPDA

Plan: \$25,000 average premium issued to a male age 55. Annual interest rate reset. Minimum interest guarantee 3.0%. Death benefit is cash surrender value. Modeled annuitization option is five-year certain, with annuitization interest rate equal to portfolio yield less 2.0% with a minimum of 3.0%.

Credited Interest: The upper tier gets a credited rate 4.0% higher than the lower tier for the first five years, and 2.0% higher for the next five years. The spread on the lower tier is 2.0% more in years 1-10 than in year 11 and later years. For example, the lower tier may be credited 3.0% for years 1-10 and 5.0% thereafter, while the upper tier would be credited 7.0% for years 1-5 and 5.0% thereafter.

Surrender Charges: 7.0% in the first year, grading down linearly to 0.0% in the eighth year.

Partial Withdrawals: None.

Commission and Acquisition Expense: 8.0% of premium.

Maintenance Expense: \$50 per policy, no inflation.

Mortality: 1983 IAM.

Base Lapse: 1% in year one, 2% in year two, 3% in years three through seven, and 5% in year eight and thereafter.

Dynamic Excess Lapse: $2 * (\text{INDEX} - \text{CR})$, where
INDEX = competitor rate - threshold,
Competitor rate = 6 month average of five-year Treasury,
Threshold = 1.50%,
CR = credited rate, and
Maximum total lapse rate = 40%.

Base Annuitization: 0% in year one, 5% in years two through five, 10% in years six and seven, 7% in years eight through fifteen, and 60% in year sixteen and thereafter.

Dynamic Excess Annuitization: Same as excess lapse, except the formula is $2 * (\text{INDEX} - \text{CR})^2$ and the threshold is 1.0%.

Statutory Reserve: During accumulation period, a percentage of upper tier value equal to 92% in year one and 90% in the second and later years. For annuitizations, the reserve interest rate is $.03 + 0.8 (20\text{-year Treasury} - .03)$, calculated at time of annuitization.

Required Capital: 3.5% of statutory reserves.

Federal Income Tax: 35% of statutory gains. No DAC tax.

Shareholder Dividends: None.

Appendix B
Proposed Definitions for an Annuity Disclosure Model Regulation

The following is letter and attachment thereto are from the American Academy of Actuaries Disclosure Work Group to Thomas Foley, chair of the NAIC Life Disclosure Working Group. The original letter was on Mr. Gorski's letterhead.

June 2, 1998

Thomas C. Foley, ASA, MAAA
Actuary
North Dakota Insurance Department
600 East Boulevard Avenue
State Capital
Bismarck, ND 58505-0320

Dear Mr. Foley,

At the request of the NAIC Life Disclosure (A) Working Group, the American Academy of Actuaries Disclosure Work Group has developed definitions of guaranteed and non-guaranteed elements suitable for inclusion in the Annuity Disclosure and Illustrations Model Regulation. During our deliberations, we determined that a third definition was necessary for products with values based on a guaranteed process. This situation is addressed with the definition of determinable elements. The definitions are attached as Attachment 1.

The Academy Work Group felt that it was important to review the current draft of the Model Regulation to assess the impact of the recommended definitions and make recommendations as to changes to the Model Regulation in order to remain consistent with recommendations previously made by this and other Academy groups. Since the NAIC Model Regulation is still in a state of flux relative to certain key elements, our review stopped at the end of Section 7 of the Feb. 20, 1998, draft. We have limited our recommendations to implementing our proposed definitions of guaranteed, non-guaranteed, and determinable elements. Absence of comments or recommendations on a specific topic in the Model Regulation should not be interpreted as concurrence with language or concept. The following are our recommended changes and comments concerning Sections 1 through Section 7 of the Model Regulation.

Section 1. - No changes recommended relative to our definitions.

Section 2. - No changes recommended relative to our definitions.

Section 3. - No recommendations for changes. We reviewed Paragraph B and felt that no change was necessary.

Section 4. - The following definitions may change as the work of the NAIC Working Group progresses and when the definitions are finalized we may have some recommendations for changes but at this time we do not.

Currently Payable Scale, Disciplined Current Scale, Illustrated Scale, Illustration, Illustration Actuary, Lapse Supported Illustration, Self-Supporting Illustration

The definition of Equity-Indexed Annuity extends only to deferred annuities. Given that the scope of the draft Regulations extends to both deferred and immediate annuities, we are unsure as to the reasons underlying the proposed definition of Equity-Indexed Annuity.

We question the need and purpose of the definition of Interest Indexed Annuity. Are special rules being considered for this type of annuity? Is an Interest Indexed Annuity considered to be different than an Equity-Indexed Annuity?

Section 5. - Paragraph B(3)(a) Replace existing sentence with the following. The guaranteed, non-guaranteed and determinable elements of the contract, and their limitations, if any, and an explanation of how they operate.

Paragraph D. Insert the phrase "and determinable" after the word "non-guaranteed."

Section 6. - Paragraph A(1) We recommend that neither guaranteed elements nor determinable elements should be used as a triggering mechanism for an insurer to provide an illustration.

We are still discussing the appropriateness of using non-guaranteed elements as a trigger for providing an illustration.

Also, the reference to "disclosure material" is ambiguous. Is "disclosure material" limited to the "Disclosure Document" discussed in Section 5 or is it a more comprehensive concept?

Section 7. - Paragraph A(2) Insert the phrase "or determinable" after the word "non-guaranteed."

A new paragraph A(4) should be added after (3) as follows: "State or imply that determinable elements are determined at issue" and renumber (4) through (8).

We will review the (4) through (8) and Paragraph B after more progress is made concerning the required illustration portion of the Model Regulation.

We are ready to discuss our recommended definitions and any of our other recommendations that are included in this matter.

Sincerely,
Larry M. Gorski, FSA, MAAA

Exhibit 1

Definitions of Guaranteed, Determinable and Non-Guaranteed Elements Solely for Use in a Model Regulation on Fixed Annuity Disclosure Developed by the Supportability Disclosure Subgroup, Disclosure Work Group, Committee on State Insurance Issues

The following definitions are intended solely to be used in a model regulation on fixed annuity disclosure. These definitions are not intended to be used for model regulations on annuity nonforfeiture or valuation, or for other model regulations covering variable annuities or other products.

Definitions

"Guaranteed Elements" means the premiums, credited interest rates (including any bonus), benefits, values, non-interest based credits, charges, or elements of formulas used to determine any of these, which are guaranteed and determined at issue. An element is considered guaranteed if all of the underlying elements that go into its calculation are guaranteed.

"Determinable Elements" means elements which are derived from processes or methods that are guaranteed at issue and not subject to company discretion, but whose values or amounts cannot be determined until some point after issue. Such elements include the premiums, credited interest rates (including any bonus), benefits, values, non-interest based credits, charges, or elements of formulas used to determine any of these. These elements may be described as guaranteed but not determined at issue. An element is considered determinable if it was calculated from underlying determinable elements only, or from both determinable and guaranteed elements.

"Non-guaranteed Elements" means the premiums, credited interest rates (including any bonus), benefits, values, non-interest based credits, charges, or elements of formulas used to determine any of these, which are subject to company discretion, and are not guaranteed and not determined at issue. An element is considered non-guaranteed if any of the underlying non-guaranteed elements are used in its calculation.

Examples

Examples of Guaranteed Elements would include the initial rate and accumulated value at the end of the first year for a typical SPDA. Examples of Non-Guaranteed Elements would include a renewal rate and the accumulated value at the end of the second year for a typical SPDA. Examples of Determinable Elements would include a guaranteed published index used to determine the credited rate for an indexed product, and the value at the end of that year for that product assuming it was calculated with a guaranteed participation rate and no other non-guaranteed elements.

ATTACHMENT THREE-D

Survey of First-Year Company Experience Under Life Illustration Regulations Based on the New NAIC Model

Report of the Disclosure Working Group
Committee on State Life Insurance Issues
June 1998

This report was prepared by the American Academy of Actuaries Disclosure Work Group of the Committee on State Life Insurance Issues at the request of the NAIC Life Disclosure Working Group. Members of the Academy work group are:

| | |
|---|------------------------------------|
| Stephen J. Preston, FSA, MAAA, Co-Chairperson | |
| Barbara Lautzenheiser, FSA, MAAA, FCA, Co-Chairperson | |
| Donna R. Claire, FSA, MAAA | John B. Dinius, FSA, MAAA |
| Robert G. Frasca, FSA, MAAA | Richard J. Fuerstenberg, FSA, MAAA |
| Larry M. Gorski, FSA, MCA, MAAA | James P. Greated, FSA, MAAA |
| Jane L. Hamrick, FSA, MAAA | Frank S. Irish, FSA, MAAA |
| Richard C. Murphy, FSA, MAAA | Richard E. Ostuw, FSA, MAAA |
| Timothy C. Pfeifer, FSA, MAAA | Lisa V. Reitano, FSA, MAAA |
| Richard P. Smolinski, FSA, MAAA | Elizabeth A. Sutherland, FSA, MAAA |
| Roger K. Wiard-Bauer, FSA, MAAA | |

Special thanks is owed to the Work Group's Life Illustrations Survey Subgroup. The subgroup took the lead in designing the survey, overseeing its administration and coding, and preparing the analysis for the larger work group. Richard Ostuw chaired the subgroup. Its other members included Donna Claire, John Dinius, Richard Fuerstenberg, Jane Hamrick and Roger Wiard-Bauer. Special thanks are due Charlotte S. Liptak, J.D., who participated at all stages of the development and analysis of the survey.

I. INTRODUCTION

At the request of the NAIC, the American Academy of Actuaries conducted a survey of companies' first year of experience under state regulations based on the NAIC Life Insurance Illustrations Model Regulation. For convenience, this report refers to the model and the array of state regulations as "the Regulation." This report presents findings from the company survey.

II. METHODOLOGY

The life illustration survey was sent to chief actuaries of U.S. life insurance companies. It requested that the chief actuary coordinate the company's response to the survey. In cases where the company did not have a chief actuary on its internal staff, an attempt was made to route the survey to an appropriate company official. Chief actuaries were identified through the current membership records of the Society of Actuaries. To include companies without chief actuaries, the American Council of Life Insurance (ACLI) and the National Alliance of Life Companies (NALC) agreed to send the survey to their member companies requesting that it be routed to the appropriate respondent.

Responses were collected from mid-January through mid-February 1998. Each response represented an individual life insurance company's experience. A total of 88 companies responded to the survey. Of these, 83 (more than 90%) responded to most questions. The remaining five companies did not respond to any of the questions. The primary reason given for not responding was a lack of any relevant experience with the new sales illustration regulation. Many of the 83 respondents provided narrative comments in addition to choosing among the pre-coded answers. Narrative responses were recorded and considered throughout the analysis.

The survey was lengthy. This is because the regulation affects many aspects of the business of life insurance including: sales methods, policyholder communications and product design. Moreover, it covered information within several areas of responsibility, including the responsibilities of illustration actuaries and responsible officers, of underwriters and of information systems officers. Although the survey covered several areas of responsibility, each company was requested to provide a single response for each question using judgement concerning the product lines and distribution systems covered.

In order for the Academy to maintain the confidentiality of survey respondents, the identities of companies and details of specific responses are not revealed in this report.

III. SUMMARY OF MAJOR FINDINGS

The NAIC Life Insurance Illustrations Model Regulation has the stated purpose of providing rules for life insurance illustrations that will protect consumers and foster consumer education. During its development, alternatives were considered and efforts made to find workable solutions for logistical and implementation concerns expressed by the industry. Marketplace changes and innovations since the adoption of the model and similar state regulations may need to be considered. The survey gathered information on the companies' perspectives on these issues.

Meeting the Regulation's Purpose

The Regulation seems to have been reasonably successful at meeting its stated purpose. Illustrations are being shown to applicants and signed. They also tend to be longer with some improvement in consumer understanding. A majority of companies are using illustrations for many of their individual life products. Based on the significant increase in the number of pages used for illustrations, more information is being given to consumers. Forty percent of companies that commented on consumer understanding believed that the illustrations were helping consumers more than the previous ones. Another 40% believed that the effects were not significant. Slightly more than half of the companies are having at least 75% of illustrations returned with signatures, when the illustrations are mailed by the company.

Workable Solutions

In many cases, solutions proposed during the Regulation's development have been workable. Companies are usually receiving policyholder signatures.

A majority of companies use fully allocated expenses for actuarial testing, while most others use the Generally Recognized Expense Table (GRET) which reflects industry average expenses. A substantial minority made at least minor changes to their expense allocation methods. Some report that the GRET should be more product specific including some adjustments for first-year dump-in premiums on universal life and policies with small face amounts. Some also felt that the GRET was overly strict. Respondents report elements of rate regulation, difficulties in designing products that reward persisting policy holders, and aspects of a non-level playing field among products.

The regulation has had some possible negative impacts. Comments reflected difficulties with work site products, policies with smaller face amounts, a variety of widely-sold products, and illustration of sophisticated scenarios (e.g., "split dollar"). An adverse impact on the levels of illustrated non-guaranteed elements was reported by a minority of respondents. With respect to

the actuarial tests, they also reflected difficulties with persistency bonuses, rapid build ups of cash values, and policies with small face amounts. Thirteen percent of respondents reported a significant adverse impact on sales. A broad variety of reasons were cited for potentially negative sales impacts including the increased length of illustrations.

Other Regulatory Issues and Suggestions For Annuity and Variable Product Regulations

Comments to a variety of general questions cover a wide range of issues and reflect some difficulties with ambiguities under the new regulation and state-to-state variations in requirements. Some support was noted for selective transfer of Q&A and Practice Notes material to the Regulation or Actuarial Standard of Practice (ASOP) No. 24. For example, actuarial testing practices with respect to riders and reinsurance tend to vary.

The survey responses show wide use of illustrations and some indication that the use of laptop computer screen illustrations may continue to grow.

Some expressed concern that regulations applicable to fixed annuities and/or variable life and annuity products should be less burdensome and maintain a level playing field for annuities with non-insurance financial accumulation products. Some comments support increased use of disclosure for certain types of product features, perhaps as a substitute for annuity actuarial testing.

IV. LIFE ILLUSTRATION SURVEY FINDINGS

The questions in the survey focused on impact of the regulation on:

- the marketing process
- agent and policyholder signature requirements
- non-guaranteed elements
- product design
- new sales illustration systems
- annual report systems
- self-support and lapse-support tests, and
- other regulatory issues.

Findings in each area are discussed below. The questionnaire and a question-by-question tabulation of responses are appended.

Impact on Marketing Process

1. Percentage of policies subject to the regulation

The results are very much as expected. The categorized responses indicate that, for 70% of the companies, illustrations are potentially required for at least 75% of individual life insurance policies sold. However, companies' comments on the question suggest that the percentage may be somewhat higher. It appears that at least a couple of respondents included policies that have only guaranteed benefits. It also appears that if variable policies were covered, the percentage would also increase.

2. Use of laptops in lieu of printed illustrations

Twenty percent of respondents did not know how illustrations were presented for their products. Of those that did, about two-thirds estimate that less than 10% of their sales requiring illustrations are based on showing consumers illustrations on a laptop with no printed copy. Comments on this question indicate that the percent using laptop illustrations may increase over time and once the regulations is applicable to variable products.

3. Use of generic vs. individualized quotations in the employer market

About two-thirds of companies either did not respond or commented that they were not in the non-term group-life market. Of the nearly one-third of companies that are in this market, a little more than 6 out of 10 indicated that only generic quotations are used. The remaining 38% provide each employee with a personalized illustration.

4. Satisfying requirements for direct market sales

Nearly 60% of the companies did not have experience with direct market (i.e., non-producer) sales in the individual life insurance market. Of those with experience in direct market sales, at least 60% are not using illustrations. Most of the others are providing an illustration based on personalized information.

Agent and Policyholder Signature Requirements

1. Distribution system

In answering questions on signature requirements, 77 of the 80 companies based their responses on producer-sold business. Of the remaining three companies, one based its responses on telemarketed business, and two based their responses on other types of direct marketing.

2. Percent of policies requiring a post-application illustration

Nearly a third of companies said that at least 75% of their policies requiring illustrations required that one be provided after an application has been submitted to the company. Some commented that this was because illustrations were automatically sent with policies and because of changes in the crediting rate from time of application.

Another third of the companies said that less than 25% of their policies required post-application illustrations. The final third were split about evenly between the 25-to-50% and 50-to-75% ranges.

3. Percent of customers returning company-sent, post-application illustrations

More than half of the companies are experiencing at least a 75% return rate on signed illustrations, when the final illustrations are mailed out by the company. For 20% of the companies, the return rate of signed illustrations is under 25%.

4. Procedures being used to meet signature requirements

Companies use a range of methods for encouraging that illustrations are signed and returned, and any given company may use more than one method. Responses were fairly evenly split among four procedures: Requiring a signature before processing the application, before issuing the policy, before paying commissions, or by making a good faith effort to get a signature after issuing the policy. Of the seven other procedures that were written in, the most common was initially crediting commissions, but reversing the credit if the signed form was not received within a specified time.

Impact on Consumer Understanding and the Sales Process

1. Improvements in consumer understanding

Eighty percent of those responding for their company felt they had sufficient experience to have an impression of how the new regulations were affecting consumers' understanding of the products they purchase.

Forty-one percent believed that the new illustrations were helping consumers more than the previous ones had, and 40% believed that the old and new illustrations contributed about the same to consumer understanding. However, companies are not without concerns. Specific concerns included the length of the illustration, whether the consumer actually read it (even though the information has been improved), and whether there would be sufficient protection in a high interest rate environment.

2. Impact on overall sales of the companies' products

Of the 86% of companies with experience to share, nearly 80% said that the new regulations have not had a major impact on sales. Of the remaining 20%, about two-thirds felt the new regulations had hurt sales while a third felt the new regulations had actually contributed to higher sales.

Comments on how the regulation has hurt sales included: Lack of consumer understanding of the illustrations themselves, and changes in the competitive environment as a result of the new regulation among which was listed difference in interpretations that have caused competitive problems. Other reasons listed for sales having been hurt related to agents. Comments here included individual statements such as the following: giving agents another reason not to sell life products, agents moving to non-illustrated products, agents not making lower premium sales, an increase in time to complete the sale, resistance of the agents to the longer illustration. Finally, there were such reasons as additional paper and signatures, delay in getting compliant illustrations to the field, and clients liking universal life less because they better understand its non-guaranteed design.

Impact on Non-guaranteed Elements

1. Impact on the level of illustrated non-guaranteed elements

Of those companies with experience, the overall level of non-guaranteed elements did not change for 68%. They became less favorable for 31% of companies. Only one of the 72 companies with experience in this area said that illustrated non-guaranteed elements become more favorable to the policyholder.

2. Paid vs. illustrated non-guaranteed elements

The vast majority of companies are crediting and charging the same non-guaranteed elements as illustrated.

Impact on Product Design

1. Product design modifications

Nearly half of companies have not changed their products in response to the new regulation of sales illustrations nor do respondents think that any change is likely.

The other half of the companies already have or expect to change the design of some or all of their products. Moreover, the list of possible areas for modification is fairly long, including commissions, charge-backs, guarantees provided, credited interest

rates, current mortality charges, current expense charges, and product illustration. Very few companies identified changes to surrender charges and loan programs.

In their comments companies mentioned other product design features for potential modification including persistency bonuses, elimination of annuity side funds, issue limit changes (e.g., age range, minimum amount), current premiums on indeterminate premium products, and shifts in load structure to earlier years.

2. Products and features that do not fit well under the regulation or actuarial tests

On treatment under the regulation, comments reflected difficulties with work site products, indeterminate premium products, adjustable life products, concept illustrations (e.g., split dollar), how to handle certain scenarios in the numeric summary, equity-indexed products, concern about portfolio rates being used when new money rates are lower, and certain whole life situations (e.g., premium offset, withdrawals).

On treatment under actuarial tests, comments reflected difficulties with the no-lapse assumption after the fifth policy duration, persistency bonuses, indeterminate premium products, products with rapid build up of early cash values, and small face amount policies.

Comments were made related to the application of the current-version GRET first-year factors, particularly for universal life dump-ins.

3. Impact of the lapse-support test on product innovations

Close to 80% said that the lapse-support test did not cause problems with product innovations. Of those that did find the test troublesome, a number indicated the test was too strict, particularly with respect to the inability to adjust mortality and expense assumptions. Others said that third party administrator costs, levelized commissions and reinsurance arrangements did not model well.

New Sales Illustration Systems

1. Cost of sales illustration systems for new sales

About 40% of companies spent under \$100,000 modifying their existing or building a new illustration system for new sales. An additional 45% spent somewhere \$100,000 and \$500,000. For a significant 17% minority, the cost exceeded half a million dollars. One of the 77 responding companies incurred costs of more than \$1.0 million.

2. Controls on illustrated scales

More than 90% of companies have some type of system in place to control the level of non-guaranteed elements that the agent can illustrate. Moreover, it is generally true that the only non-guaranteed element the agent can change is the credited rate. This was indicated repeatedly in supplementary comments which were made for all of the response categories.

3. Average length of illustrations for new sales

Fewer than 10% have illustrations that average five or fewer pages. Much longer illustrations are clearly the rule. A little more than 40% of companies report illustrations that average at least 10 pages.

4. Change in length of illustration for new sales

For more than 95% of companies, illustrations are longer under the new regulations. For 40%, illustrations are three or four pages longer. And, for nearly 45%, illustrations are five or more pages longer, the highest category specified in the questionnaire. The increased length of illustrations was a significant complaint, and perhaps the greatest one, of many of the companies that responded.

5. Use of supplemental illustrations

Supplemental illustrations are used for a variety of purposes—primarily for concept illustrations (e.g., for split dollar) and voluntary policyholder actions (e.g., loans).

In-force Illustration Systems

1. Cost of illustration systems for in-force business

Half of the companies spent under \$100,000 modifying or building illustration systems for in-force business. Another 43% spent between \$100,000 and \$500,000. Only a small minority (6%) spent more than half a million dollars, and no one reported spending more than \$1.0 million.

2. Average length of illustrations for in-force business

Illustrations for in-force business are usually substantially shorter than those for new sales. Of the companies that were providing in-force illustrations, slightly more than half have illustrations that average five or fewer pages. An additional 30% had illustrations of less than eight pages. Only 7% had illustrations that averaged 10 or more pages.

Annual Report Systems

1. Annual report format for policies subject to and not subject to the regulation

Of the 91% of companies using annual reports, 85% were creating a new format for business subject to the new regulations. More than 60% will use the new format for both business subject and not subject to the new illustration requirements.

2. Costs for new or revised annual report systems

Eight-two percent of companies that use annual reports said there was some initial cost to revising annual report systems. A large majority (85%) said the cost was under \$100,000. Most of the rest reported costs of between \$100,000 and \$200,000. Ten percent of those with start-up costs reported costs of \$200,000 or more.

Self Support and Lapse Support Tests for New Sales and In-force business

1. On-going annual costs

It appears that the on-going costs of completing the new illustration regulations' testing and certification requirements have not significantly increased expenses. Eighty-five percent said the costs were \$100,000 or less and no one said the costs exceeded \$200,000.

Of those companies that specified the source of additional costs, the time commitment of the illustration actuary was the most common reply.

2. Additional initial costs

The initial cost of implementing the certification requirements also appears modest for most companies, with 10% incurring no extra first-year costs and 75% incurring \$100,000 or less. This was not true for all companies; 14% reported costs between \$100,000 and \$500,000 and one company reported costs between \$500,000 and \$1 million. Some of the higher initial expenses were due to the cost of hiring consultants to review the testing process and the having illustration actuaries attend seminars.

3. Modification of expense allocations

For more than half (55%) of companies, it was not necessary to update expense assumptions. Of the 40% that did modify expense allocations, slightly more than half described the changes as "some refinements," rather than as "a thorough review." Several said they had planned to review expense allocations anyway. Of the 18% of companies that thoroughly reviewed and updated their expense allocations, four-out-of-ten ended up using the GRET. The rest used fully allocated.

Of the companies who elaborated on their responses, most described minor reallocations of commissions and other expenses within a line of business. One company reported that it was forced to abandon macro-pricing methods as a result of the new regulation's requirements.

4. Expense method used

About 65% of companies are using fully allocated expenses. Most of the remainder use GRET; only 5% use marginal expenses. Some respondents indicated that their answer to this question was their current expense allocation method, and not necessarily the one they used when the new sales illustration regulations were first implemented.

5. GRET implementation problems

More than three-quarters of the companies did not report a problem implementing the GRET. Of the roughly 20% that did, the most common problems were:

Unusually high expenses allocated to first-year dump-ins on universal life products, which was mentioned by a number of companies.

GRET does not adequately distinguish between large and small policies, causing problems for policies with smaller face amounts.

GRET needs to be product-specific.

6. Modifications to investment income allocation

Virtually all companies said that they either made no change or made only some minor refinements. Of the five companies that made more major changes, two said that they implemented a portfolio crediting strategy to make it easier to demonstrate compliance with the new regulation.

7. Illustration of alternative forms of payout

Most companies do not illustrate alternative forms of payout. Of those that do, 14 illustrate more than one of the forms listed. Some companies indicated that their response to this question does not apply to all illustrated products.

8. Testing of Riders

Six out of 10 companies indicated that riders were tested separately from the base policy and were not used to help the basic coverage pass. Several companies explained that rider cash flows were aggregated with the basic coverage cash flows only if necessary to help the basic coverage pass. Some companies stated that they spent little time on riders either because their cash flows had a de minimus effect on aggregate cash flows or because the riders had no non-guaranteed elements.

9. Reinsurance

Roughly half of the companies with reinsurance have incorporated the resulting cash flows in their testing. Of those companies that did not include reinsurance, some said that ignoring the reinsurance was deemed to be conservative, while others said the impact of the reinsurance treaty was not material. Of those that used reinsurance cash flows, none indicated whether they were necessary to get products to pass the self-support and lapse-support tests. A few companies indicated that new reinsurance arrangements were created and incorporated.

10. Additional comments on self-support and lapse support

Additional comments regarding the Regulation fell into three broad categories: positive impacts, undesirable consequences of the prescribed rules, and the burden of creating and maintaining the required documentation. Specific comments in these categories were:

Positive Impacts

- Companies are more aware of their expense levels.
- Better expense allocation mechanisms may be developed.
- Illustrations will be more standardized.
- Illustrated and expected values should be closer together.

Undesirable Consequences

- Despite the best intentions, there is an element of rate regulation involved.
- The development of products that reward persisting policyholders will be limited.
- Standards are different for single life and last-survivor policies.
- It should not be acceptable to reinsure the lapse risk via levelized mortality charges.
- A reasonable inflation rate should be prescribed.
- Companies may be encouraged to purchase less secure investments to get a better yield, and there is no requirement to reflect a cost for the additional risk taken.
- Companies may be encouraged to allocate more expense to unaffected divisions.
- Companies may be encouraged to adjust pricing assumptions to pass the tests.
- Future recovery of DAC tax should be factored in (if it is not currently permitted).

Paperwork Burden

- Some relief is needed for minor assumption changes.
- Record keeping to support in-force illustration requirements for closed blocks of business will become very cumbersome.

Other Regulatory Issues

1. Training agents

Companies' agent training practices vary widely, ranging from training manuals and other written materials to face-to-face training, video and audio tapes, teleconferences, and follow-up bulletins. Many companies, of course, use multiple methods of training. About 60% send agents brief sets of instructions. In addition, about the same percent have some fact-to-face training program, and nearly a third provide extensive training manuals.

2. Ways of dealing with conflicting requirements of old regulations

While waiting for regulatory relief, many companies comply with both old and new regulatory requirements even when they are inconsistent or contain outright conflicts. Some companies seek guidance from the state insurance department; some comply with the newer regulation in the case of inconsistency or outright conflict.

3. Areas of ambiguity and state-to-state variations

Ambiguities and state-by-state variations in regulatory requirements occur in the following areas: computer screen illustrations, hardcopy illustration output and delivery, definition of other than as applied for, applicability to corporate

sponsored plans, in-force illustrations, in-force illustrations and annual statements on plans not originally illustrated, and annual statements for some term plans with only guaranteed elements in certain years. For actuarial support testing, ambiguities include: definition of policy form, acceptable methods of allocating expenses including corporate overhead, GRET allocations and permitted variations, tax effects, inclusion or exclusion of term riders, variations in voluntary actions by policy owners (e.g., policy loans and premium payment patterns), reflections of reinsurance, and annual compliance reporting (e.g., is the certification for the past year or the upcoming year?).

4. Transferring practice note material into the model regulation

Suggested transfers of information to the model regulation or ASOP No. 24 occur in the following areas: computer screen illustrations, illustration of multiple premium patterns for term insurance, formats for annual compliance communications to states, use of an interest margin versus specified interest rates in testing, testing of indeterminate premium term insurance, two-tier product requirements, application of inflation assumptions (especially to the GRET), and more general inclusion of the Q&A and Practice Notes.

5. Aspects of the illustration regulation applicable to annuities and variable life

Respondents addressed a wide variety of issues when asked to note aspects of the Life Illustration Regulation that *should* be applied to fixed annuity or variable life and annuity illustration regulations. Some expressed concern about a level playing field for annuities versus other financial products and a desire that annuity illustrations be simpler and shorter than the life illustrations. Disclosure concerning fixed annuity first-year bonus interest rates is noted. Disclosure for variable products is generally deemed to be adequate. Some disclosure concerning gimmicks is noted. Some concern about state-by-state variations in regulatory requirements. There was some support for standard illustration formats for each major family of products.

Some support was reported for actuarial standards and self-support tests for fixed annuities and variable products with some (numerically different) GRETS to be made available and the use of a mid-point scale for fixed annuities. However, concerns were expressed about the burden of actuarial support testing and some opposition to actuarial support testing is noted in responses to question 6 below and a desire to focus on disclosure as an alternative to support testing.

6. Aspects not applicable to annuities and variable life

Respondents addressed a wide variety of issues when asked to note aspects of the Life Illustration Regulation that *should not* be applied to fixed annuity or variable life and annuity illustration regulations. Some concern about state-by-state variations in regulatory requirements is noted. A desire was expressed to maintain consistency with current variable product disclosure requirements and maintain the 12% interest rate cap. The regulation should not require illustrations, should permit annuity illustrations to be simpler and shorter than life illustrations, and should not require signatures. Concerns were expressed about maintaining a level playing field for annuities versus other financial products. For fixed annuities, the definition of currently payable scale may need to be more flexible; the prevalence of new money products was noted. Some assert that actuarial support testing should not be required for fixed annuities and variable products, instead, focus should be placed on disclosure requirements. A desire to minimize or eliminate the narrative summary requirements was noted.

7. Additional comments on the new regulations and this survey

Concerns were expressed about: burdens on small companies and distributors, state-by-state variations in regulatory requirements, short notice between adoption of a regulation and the effective date, the length of illustrations helping to confuse consumers, the relative riskiness of assets not being reflected in assumed investment yield rates, and difficulty in treating temporary excess expenses as a capital investment for illustration purposes. A practice of filing two nearly identical policy forms, one for illustration and one not-to-be-illustrated, was noted. A desire was expressed for the elimination of actuarial support testing for a product once it reached the end of the twentieth year from issue.

APPENDIX A SURVEY QUESTIONS AND TABULATION OF RESPONSES

Cover Memorandum to Chief Actuaries

To: Chief Actuaries
From: Stephen Rentner, Public Policy Analyst
Re: Survey of Company Experience Under Life Illustration Regulations
Date: January 21, 1998

At the request of the NAIC, the American Academy of Actuaries is conducting a survey concerning the first year of experience under state life insurance illustration regulations (collectively referred to as "the Regulation") that have been based on the NAIC's model regulation. The Academy will tabulate the survey results by question. The identities of companies and details of specific surveys will be held confidential by the Academy.

This survey is lengthy because the Regulation impacts many aspects of selling life insurance, communicating with policy holders after the sale, and developing new products. We appreciate your patience with this survey's length. The feedback from this survey will potentially:

1. Help improve the Life Illustration Regulation, and
2. Impact the anticipated development of an NAIC Model Fixed Annuity and/or Variable Life and Annuity Regulation.

This survey covers ground within several areas of responsibility for many life insurance companies, which includes responsibilities of illustration actuaries, responsible officers, underwriters, information systems officers, etc.

Given the several areas of responsibility involved, we ask that you or your designee:

1. Allocate responsibility for specific questions among your colleagues, and
2. Provide one coordinated set of responses on behalf of your company.

All individual company responses and associated material will be kept confidential. Envelopes have been provided for this purpose. Your cooperation and assistance will be greatly appreciated. The Academy wishes to provide a report of the results of the survey to the NAIC at its March meeting. As a result, we ask that you complete and return the survey by Feb. 13, 1998.

Survey Directions

Most questions have a list of answers from which to choose. Also, each question has a comment area, plus there is additional space at the end of the survey for comments. Please note that the phrase "nonguaranteed elements" as used in this survey includes all items set at the discretion of the company, including policyholder dividends on participating products.

| Count | Percent | Survey Question |
|-------|---------|--|
| | | Impact on the Marketing Process |
| | | 1. What percentage of total individual life insurance policies sold that are <u>potentially</u> subject to the regulation are being designated as <u>requiring the use of a sales illustration</u> ? |
| 7 | 9 | a. Under 25%. |
| 9 | 11 | b. 25% up to 50%. |
| 8 | 10 | c. 50% up to 75%. |
| 56 | 70 | d. 75% and over. |
| 80 | 100 | |
| | | 2. For the policies designated as using an illustration, are the agents for your company using computer screen displays <u>without a printed illustration to sell the insurance</u> ? |
| 41 | 53 | a. Under 10% of the sales seem to be based on showing information to consumers on a computer screen. |
| 10 | 13 | b. Between 10% and up to 25% of sales seem to be based on showing information to consumers on a computer screen. |
| 4 | 5 | c. Between 25% and up to 50% of sales seem to be based on showing information to consumers on a computer screen. |
| 6 | 8 | d. 50% or more of the sales seem to be based on showing information to consumers on a computer screen. |
| 16 | 21 | e. No experience to share on this question. |
| 77 | 100 | |
| | | 3. Employer Market - Are "generic quotations" for "non term group life" being used in employee meetings? |
| 1 | 2 | a. Yes, the company's policy is that everyone gets the same quotation of only one or two ages, policy sizes, and premium pattern examples. |
| 5 | 8 | b. Yes, the company's policy is that everyone gets a quotation with a number of different ages, policy sizes, and premium patterns. |
| 4 | 7 | c. Yes, the company's policy is that each individual gets a quotation with a few specific examples for their age and/or salary level. |
| 6 | 10 | d. Yes quotations are used, but the agent determines what quotations will be provided. |
| 34 | 56 | e. Other (please explain below) |
| 10 | 17 | f. No, each employee gets a personalized illustration. |
| 60 | 100 | |
| | | 4. Direct (non producer-sold) Market - How are illustration requirements being satisfied? |
| 15 | 20 | a. Policies are designated by the company to be sold without an illustration. |
| 0 | * | b. A pre-packaged illustration containing information for a number of sample issue ages is being provided, and none of the other information is based on the individual customer. |
| 2 | 3 | c. A pre-packaged illustration is used based on the person's issue age and gender, and none of the other information is based on the individual customer. |
| 48 | 66 | d. No experience in this market. |
| 8 | 11 | e. Other (please explain below). |
| 73 | 100 | |

| | | Agent and Policyholder Signature Requirements (Please base the responses in this section of the survey on the type of distribution system indicated in the response to the first question.) |
|-----|-----|--|
| | | 1. Are the responses in this section of the survey based on: |
| 77 | 96 | a. producer-sold business |
| 2 | 3 | b. directly-marketed other than telemarketed business |
| 1 | 1 | c. telemarketed business |
| 80 | 100 | |
| | | 2. For policies designated to be sold with an illustration, what percent of the issued policies need to have an illustration provided to the consumer after the application has been sent to the company. (The agent or company provides an illustration later, including, for example, policies issued other than applied for)? |
| 26 | 34 | a. less than 25%. |
| 15 | 19 | b. % up to 50%. |
| 13 | 17 | c. 50% up to 75%. |
| 23 | 30 | d. 75% or above. |
| 77 | 100 | |
| | | 3. For those policies mailed to the customer by the company that contain an illustration, what percent of these customers are sending back a copy with their signatures? |
| 12 | 20 | a. less than 25%. |
| 7 | 12 | b. 25% up to 50%. |
| 8 | 14 | c. 50% up to 75%. |
| 32 | 54 | d. 75% or above. |
| 59 | 100 | |
| | | 4. What procedures has the company put in place with respect to the signature requirements? (Please mark all that apply) |
| 24 | 21 | a. The company requires a signed form before the application will be processed. |
| 24 | 21 | b. The company will process the application, but will not issue a policy without a signed form. |
| 28 | 25 | c. The company withholds commissions until a form is signed. |
| 30 | 27 | d. The company issues the policy and completes a "good faith effort" to get a signature from the policyholder, such as including a postage paid return envelope for the policyholder to use. |
| 0 | * | e. No experience to share on this item. |
| 7 | 6 | f. Other (please explain below). |
| 113 | 100 | |
| | | Impact on Consumer Understanding and the Sales Process |
| | | 1. Is it your impression, based on your company's experience, that consumers understand their purchases better by receiving illustrations under the Regulation compared to the pre-Regulation illustrations? |
| 8 | 10 | a. No, the old illustrations we used before helped consumers more. |
| 26 | 31 | b. About the same - the old and new illustrations are about the same. |
| 21 | 26 | c. Yes, the new illustrations are helping consumers a little more than the old illustrations. |
| 6 | 7 | d. Yes, the new illustrations are much better than the old illustrations. |
| 16 | 20 | e. No experience to share on this question. |
| 5 | 6 | f. Other (please explain below). |
| 82 | 100 | |
| | | 2. Is it your impression that the Regulation has had the following impacts on overall company sales (please mark all that apply): |
| 13 | 14 | a. No experience to share on this question. |
| 2 | 2 | b. Sales are hurt by the Regulation due to lack of consumer understanding of the illustration. |
| 1 | 1 | c. Sales are hurt by the Regulation due to better consumer understanding of the illustration. |
| 2 | 2 | d. Sales are helped by the Regulation due to better consumer understanding. |
| 7 | 7 | e. Sales are hurt by the Regulation due to a change in the competitive environment. |
| 7 | 7 | f. Sales are helped by the Regulation due to a change in the competitive environment. |
| 14 | 15 | g. Sales are hurt by the Regulation for other reasons (please list below). |
| 2 | 2 | h. Sales are helped by the Regulation for other reasons (please list below). |
| 48 | 50 | i. The Regulation has not had a major impact on sales. |
| 96 | 100 | |
| | | Impact on Nonguaranteed Elements |
| | | 1. For your company, the overall level of illustrated nonguaranteed elements: |
| 49 | 64 | a. Has not been impacted by the Regulation. |
| 22 | 29 | b. Has become less favorable to the policyholder due to the Regulation. |
| 1 | 1 | c. Has become more favorable to the policyholder due to the Regulation. |
| 5 | 6 | d. No experience to share on this question. |
| 77 | 100 | |

| | | |
|-----|-----|--|
| | | 2. For your company, the level of credited and charged nonguaranteed elements and the level of illustrated nonguaranteed elements are: |
| 68 | 91 | a. The same. |
| 6 | 8 | b. In aggregate effect, the credited and charged NGEs are generally more favorable to the policyholder than those illustrated. |
| 1 | 1 | c. No experience to share on this question. |
| 75 | 100 | |
| | | Impact on Product Design |
| | | 1. For your company, has the impact of the Regulation contributed to or is likely to contribute to modifications in product designs? (Please mark all that apply.) |
| 28 | 17 | a. None for any products |
| 6 | 4 | b. Surrender charges |
| 10 | 6 | c. Commissions or charge-backs |
| 13 | 8 | d. Guarantees provided |
| 25 | 15 | e. Credited Interest Rates |
| 17 | 10 | f. Current mortality charges |
| 16 | 10 | g. Current expense charges |
| 18 | 10 | h. Any other nonguaranteed elements (including dividends) |
| 3 | 2 | i. Loan program |
| 13 | 8 | k. Other product design features (please list in comment section below) |
| 16 | 10 | l. How a product was illustrated |
| 165 | 100 | |
| | | 2. Please describe any products or features that <u>did not fit well under the Regulation or the self-support or lapse-support testing</u> (please include the "how's and why's"). |
| | | A partial list of items to consider is shown below: |
| | | Term Surrender Charges |
| | | Indeterminate premium Loans |
| | | Equity-indexed Life Persistency Bonuses |
| | | Whole Life Group Insurance |
| | | Joint - first to die Joint - last to die |
| | | UL Work site marketing |
| | | Direct marketing Other |
| | | Target Premium |
| | | 3. Has the 100% persistency assumption in years six and later for the lapse-support test impacted product innovations? (Please identify areas that the lapse test fail to give reasonable results and identify whether the tests were too easy or too hard in the comment section below). |
| 56 | 77 | a. No difficulties were experienced. |
| 2 | 3 | b. Third-party administrator costs did not model well under the tests. |
| 2 | 3 | c. Levelized commissions did not model well under the tests. |
| 5 | 7 | d. Reinsurance arrangements did not model well. |
| 7 | 10 | e. Other (please list in comment section). |
| 72 | 100 | |
| | | New Sales Illustration Systems |
| | | 1. What additional costs were experienced to modify or build an illustration system for new sales? "Additional costs" include software, hardware, other information system costs, development and production of written materials video etc., training of producers and distribution management, additional compliance supervision, etc. |
| 3 | 4 | a. None. |
| 26 | 34 | b. up to \$100,000. |
| 19 | 25 | c. \$100,000 up to \$200,000. |
| 16 | 21 | d. \$200,000 up to \$500,000. |
| 12 | 15 | e. \$500,000 up to \$1,000,000. |
| 1 | 1 | f. \$1,000,000 up to \$2,000,000. |
| 0 | * | g. \$2,000,000 or more. |
| 77 | 100 | |

| | | |
|-----|-----|--|
| | | 2. Under the Regulation, what controls are used on the illustrated scale of nonguaranteed elements (NGEs)? |
| 22 | 27 | a. Only the official NGEs can be illustrated and a new copy of the software is provided to the agent when the scale of NGEs changes. |
| 12 | 15 | b. Only the official NGEs can be illustrated and a "key" is provided to the agent when changes are made, but a new copy of the software is not needed. |
| 30 | 36 | c. Software supports agent illustration of any scale of NGEs not more favorable to the policyholder than the official NGEs. |
| 9 | 11 | d. Software supports agent illustration of any scale of NGEs. |
| 9 | 11 | e. Other (please explain below). |
| 82 | 100 | |
| | | 3. What is the average length of the new sales illustration given to consumers? |
| 7 | 8 | a. 5 pages or less. |
| 21 | 26 | b. 6 or 7 pages. |
| 17 | 21 | c. 8 or 9 pages. |
| 23 | 28 | d. 10 or 11 pages. |
| 11 | 13 | e. 12 or more pages. |
| 3 | 4 | f. Not applicable. |
| 82 | 100 | |
| | | 4. How many pages longer is the Regulation's format than the format your company used to use? |
| 1 | 1 | a. It is shorter. |
| 2 | 2 | b. It is the same. |
| 6 | 8 | c. It is 1 to 2 pages longer. |
| 31 | 40 | d. It is 3 or 4 pages longer. |
| 34 | 44 | e. It is 5 or more pages longer. |
| 4 | 5 | f. Not applicable (such as no illustrations where used before, etc.). |
| 78 | 100 | |
| | | 5. Please describe how Supplemental Illustrations are being used by your company and/or its producers. (Please mark all that apply.) |
| 21 | 18 | a. Used less frequently than before. |
| 12 | 10 | b. Used more frequently than before. |
| 9 | 8 | c. Used to illustrate the effect of changes in scales of NGEs. |
| 34 | 29 | d. Used to illustrate the effects of voluntary policyholder actions (e.g., partial withdrawals, loans, premium dump-ins, partial withdrawals). |
| 14 | 12 | e. Used to illustrate results when combined with other financial products. |
| 26 | 23 | f. Other (please explain, below). |
| 116 | 100 | |
| | | In-force Illustration Systems |
| | | 1. What additional costs were experienced to modify or build an illustration system for <u>in-force</u> business? "Additional costs" include software, hardware, other information system costs, development and production of written materials video, training of producers and distribution management, additional compliance supervision, etc. |
| 6 | 9 | a. None. |
| 29 | 42 | b. up to \$100,000. |
| 21 | 31 | c. \$100,000 up to \$200,000. |
| 8 | 12 | d. \$200,000 up to \$500,000. |
| 4 | 6 | e. \$500,000 up to \$1,000,000. |
| 0 | * | f. \$1,000,000 up to \$2,000,000. |
| 0 | * | g. \$2,000,000 or more. |
| 68 | 100 | |
| | | 2. For in-force illustrations that are <u>not</u> part of an annual report, what is the average length of the in-force illustration given to consumers? |
| 36 | 47 | a. 5 pages or less. |
| 21 | 27 | b. 6 or 7 pages. |
| 8 | 11 | c. 8 or 9 pages. |
| 4 | 5 | d. 10 or 11 pages. |
| 1 | 1 | e. 12 or more pages. |
| 7 | 9 | f. Not applicable. |
| 77 | 100 | |
| | | Annual Report Systems |
| | | 1. Are the same annual reports planned to be used for business covered and not covered by the Regulation? |
| 7 | 9 | a. Not applicable, annual reports were not used. |
| 15 | 19 | b. No, separate formats will be used. |

| | | |
|----|-----|--|
| 11 | 14 | c. Yes, the old format will be used for both. |
| 45 | 58 | d. Yes, a new format will be used for both. |
| 78 | 100 | |
| | | 2. What additional costs were experienced to modify or build a system for <u>annual reports</u> ? "Additional costs" include software, hardware, other information system costs, development and production of written materials video, training of producers and distribution management, additional compliance supervision, etc. |
| 6 | 8 | a. None |
| 49 | 70 | b. up to \$100,000. |
| 10 | 14 | c. \$100,000 up to \$200,000. |
| 5 | 7 | d. \$200,000 up to \$500,000. |
| 0 | * | e. \$500,000 up to \$1,000,000. |
| 1 | 1 | f. \$1,00,000 up to \$2,000,000. |
| 0 | * | g. \$2,000,000 or more. |
| 71 | 100 | |
| | | Self-support and Lapse-support tests (New Sales and Inforce) |
| | | 1. What on-going costs to conduct a complete annual Illustration Actuary testing and certification process were incurred? Please exclude the "additional costs" defined as part of Question 2. below. |
| 5 | 7 | a. None. |
| 65 | 85 | b. up to \$100,000. |
| 6 | 8 | c. \$100,000 up to \$200,000. |
| 0 | * | d. \$200,000 up to \$500,000. |
| 0 | * | e. \$500,000 up to \$1,000,000. |
| 0 | * | f. \$1,00,000 up to \$2,000,000. |
| 0 | * | g. \$2,000,000 or more. |
| 76 | 100 | |
| | | 2. What <u>additional costs</u> were experienced to prepare the company to conduct Illustration Actuary testing leading to certification? "Additional costs" include software, hardware, other information system costs, education and training, and review of new policies and procedures. |
| 8 | 10 | a. None. |
| 59 | 75 | b. up to \$100,000. |
| 7 | 9 | c. \$100,000 up to \$200,000. |
| 4 | 5 | d. \$200,000 up to \$500,000. |
| 1 | 1 | e. \$500,000 up to \$1,000,000. |
| 0 | * | f. \$1,00,000 up to \$2,000,000. |
| 0 | * | g. \$2,000,000 or more. |
| 79 | 100 | |
| | | 3. Did the Regulation result in a modification of expense allocations? (Please note that it is assumed any such allocations followed generally accepted expense allocation methodologies.) |
| 14 | 18 | a. Yes, it caused a thorough review and updating of expense allocations. |
| 18 | 23 | b. Yes, some refinements were made prior to or during the testing process. |
| 43 | 55 | c. No, no updating was necessary. |
| 3 | 4 | d. Any other situation (please explain below). |
| 78 | 100 | |
| | | 4. What expense method was used by your company? |
| 51 | 63 | a. Fully allocated. |
| 24 | 30 | b. The Generally Recognized Expense Table (GRET). |
| 4 | 5 | c. Marginal. |
| 2 | 2 | d. Not applicable. |
| 81 | 100 | |
| | | 5. If the GRET was used, were there any implementation problems experienced? If so, please explain. |
| 6 | 22 | a. Yes |
| 21 | 78 | b. No |
| 27 | 100 | |
| | | 6. Were modifications made to the investment income allocations? (Please note that it is assumed that any such allocations follow generally recognized allocation methodologies.) |
| 1 | 1 | a. Yes, it caused a thorough review and updating of allocations. |
| 12 | 15 | b. Yes, some refinements were made prior to or during the testing process. |
| 64 | 80 | c. No, no updating was necessary. |
| 3 | 4 | d. Any other situation (please explain below). |
| 80 | 100 | |

| | | |
|-----|-----|--|
| | | 7. Please identify which of the following alternative payout forms are illustrated (please mark as many as apply): |
| 9 | 10 | a. Extended term. |
| 20 | 21 | b. Reduced paid up. |
| 16 | 17 | c. Annuity payouts. |
| 47 | 50 | d. None of the above. |
| 2 | 2 | e. Other (please explain below). |
| 94 | 100 | |
| | | 8. How was testing on riders completed? |
| 47 | 61 | a. Riders were tested on the side as stand alone and the positive accumulated cash flows were <u>not</u> used to help pass the basic insurance coverage. |
| 7 | 9 | b. Riders were calculated on the side and the cash flows were aggregated with the basic insurance coverage cash flows. |
| 19 | 25 | c. Riders were combined from the start and were part of the aggregated cash flows. |
| 4 | 5 | d. Other (please explain below). |
| 77 | 100 | |
| | | 9. For your company, was reinsurance incorporated into the testing? (Please mark as many as apply): |
| 32 | 35 | a. Reinsurance was not incorporated. |
| 35 | 37 | b. YRT reinsurance was incorporated. |
| 17 | 18 | c. Other types of reinsurance arrangements were incorporated. |
| 5 | 5 | d. New reinsurance arrangements were created and incorporated. |
| 2 | 2 | e. No reinsurance arrangements existed to incorporate. |
| 3 | 3 | f. Other (please explain below). |
| 94 | 100 | |
| | | 10. Please list any additional thoughts on how the self-support and lapse-support rules or the related Actuarial Standard of Practice <u>are</u> or <u>are not</u> working: |
| | | Other Regulatory Issues |
| | | 1. In what ways did your company communicate to and train its producers in the requirements of the Regulation? (Please mark all that apply.) |
| 47 | 36 | a. Sent them a brief set of instructions. |
| 24 | 19 | b. Sent them a more extensive training manual. |
| 2 | 2 | c. Sent them written material and a video tape. |
| 45 | 34 | d. Had some type of face-to-face training program. |
| 11 | 8 | e. Other (Please explain below). |
| 129 | 100 | |
| | | 2. How has your company handled possibly conflicting requirements in some states between older laws or regulations and the new Regulation? |
| | | 3. Are there any areas of ambiguity in the Regulation that, in your opinion, need to be clarified? |
| | | 4. Are there parts of the Q&A and/or the Practice Notes that you believe should be transferred to the Regulation and/or Actuarial Standard of Practice No. 24? |
| | | 5. Based on your experience with the Life Illustration Regulation, are there any aspects of the Regulation that you believe <u>should</u> be applied to fixed annuity or variable life and annuity contracts when the NAIC develops a Fixed Annuity Illustration Regulation and Variable Product Regulation? |
| | | 6. Based on your experience with the Life Illustration Regulation, are there any aspects of the Regulation that you believe <u>should not</u> be applied to fixed annuity or variable life and annuity contracts when the NAIC develops a Fixed Annuity Illustration Regulation and Variable Product Regulation? |
| | | 7. If you have any additional comments on the Regulation or this survey, please list them below: |

ATTACHMENT THREE-E

Life Disclosure Working Group
Conference Call
May 20, 1998

The Life Disclosure Working Group of the Life Insurance and Annuities (A) Committee met by conference call at 1 p.m. on May 20, 1998. Tom Foley (N.D.) chaired the meeting. The following working group members participated: John Hartnedy (Ark.); Hal Phillips representing Sheldon Summers (Calif.); Frank Dino (Fla.); Lester Dunlap (La.); Paul DeAngelo (N.J.); Cynthia Martin (Mass.); Jerry Fickes (N.M.); Dan Keating (Okla.); and Ted Becker (Texas).

The May 11, 1998, draft buyer's guide to fixed deferred annuities submitted by the technical resource advisors was discussed. Tom Foley (N.D.) asked the regulators what their initial reaction was to the advisors' draft. Mr. Foley said his own reaction was that it was "wordier" than it needed to be. John Hartnedy (Ark.) said he objected to requiring the delivery of the buyer's guide to consumers; he said that consumers in his state did not want to receive that much paper. Hal Phillips (Calif.) said he believes

that the draft needs a lot of polishing. Lester Dunlap (La.) said the draft seemed very similar to the April 15, 1998 NAIC draft and the NAIC Life Insurance Buyer's Guide. Paul DeAngelo (N.J.) said that his reaction to the advisors' draft was favorable both in its format and wording. Jerry Fickes (N.M.) said it might be a little verbose in some areas. He said he also had concerns relative to its length. Dan Keating (Okla.) also expressed a desire for a more concise document.

Riva Kinstlick (Prudential) then gave an overview of the draft. She said that the advisors had wanted to follow as much as possible the Equity-Indexed Annuities Buyer's Guide. She stated that there is a trade-off between brevity and precision, and it was difficult to achieve the right balance. Linda Lanam (Life of Virginia) also pointed out that the length was necessary in order to adequately explain all of the annuities that are sold.

A general discussion then ensued regarding exactly what would be delivered to the applicant. It was agreed that applicants for annuities other than equity-indexed annuities would not receive the appendix describing equity-indexed annuities.

A general discussion then ensued regarding the concerns over the length of the buyer's guide. Ron Panneton (National Association of Life Underwriters—NALU) stated that there was nothing being proposed to require the applicant to read the buyer's guide; if they thought it was too lengthy, they could simply ignore it. Mr. Hartnedy responded by saying that the more paper that is supplied to an applicant, the less likely it is that he or she will read any of it. Mr. Foley stated that in the absence of a requirement for the companies to provide a buyer's guide, he doubted if many would be requested by applicants. Mr. DeAngelo again pointed out that there was no requirement for applicants to either read or sign the buyer's guide; however, he said that it was important that "it's there if they need it and they will have it in their drawer if they want to refer to it." Cynthia Martin (Mass.) agreed with Mr. DeAngelo's comments.

A lengthy discussion then ensued which covered a section-by-section analysis of the draft. During that discussion agreement was reached on the following changes:

- (1) In front of "What Are the Different Kinds of Annuities," put a note with language such as "if this annuity is being used to fund a pension plan, then it is the plan itself which is controlling." Mr. Foley invited the participants on the call to send Bob Brown (CIGNA) suggestions for a one or two sentence insertion.
- (2) Delete the section labeled "Individual or Group."
- (3) Put separate headings for "Fixed" and "Variable" Annuities.
- (4) Change the title of the "Two-Tiered Annuities" section to "Multiple-Fund Annuities."
- (5) Combine the section on "Is There Always a Charge to Take My Money Out Early" with the subsection on "Surrender or Withdrawal Charges."
- (6) Delete the last sentence of the "Death Benefit" Section.
- (7) Use a term other than "Tax Qualified" in the "What About the Tax Treatment of Annuities" section.

Mr. Foley asked that language to implement the above changes and any other suggested changes be sent to Mark Peavy (NAIC/SSO) by May 27. Mr. Foley said that he hoped to distribute a revised buyer's guide one week prior to the June 21 Summer National Meeting in Boston, but he cautioned that distribution of the buyer's guide may occur at the June 21 meeting itself. Subsequent to that meeting, the buyer's guide will be provided to Brenda Cude (University of Illinois Cooperative Extension Service) for her revisions. Mr. Foley said that he anticipated holding a conference call in early July to complete work on the buyer's guide.

Next, Mr. Foley reviewed his suggestions for revising Sections 5 and 6 of NAIC draft Annuity Disclosure and Sales Illustrations Model Regulation (Attachment Three-E1). Mr. Foley stated that it is important for the disclosure documents to address the issues raised in the buyer's guide. He also stated that he is proposing that the disclosure document be permitted to show the interest crediting rate that the company is currently paying in renewal years, if the rate is self-supporting. Barbara Lautzenheiser (Lautzenheiser & Associates) said that the American Academy of Actuaries will provide a report at the Summer National Meeting in Boston on "self-supporting" and "lapse-supported," but that no recommendations will be made. Mr. Foley also noted that Section 6 has been altered to say that illustrations are optional in most cases.

A lengthy discussion ensued regarding the proposed changes to Section 5. Mr. DeAngelo said that he was more comfortable with the former, more specific language than with the new, broader language. Mr. Foley said that the reason he had changed from the more prescriptive language was that similar language in the Life Insurance Illustrations Model Regulation had resulted in 10-15 page illustrations, which still did not adequately explain the policy provisions. A general discussion then occurred regarding the degree to which it will be possible to update the regulation and/or the buyer's guide to address new product designs in a timely manner. In conclusion, Mr. Foley invited the regulators and interested parties to send in their comments by May 27 regarding whether Section 5B should be 1) prescriptive in nature or 2) broadly require that the questions in the buyer's guide be addressed. He also invited comments on any of the other revisions. Mr. Foley said that he hoped to distribute a revised draft of the regulation a week before the Summer National Meeting in Boston, but it may be that distribution is delayed until the actual meeting.

Having no further business, the Life Disclosure Working Group adjourned at 3 p.m.

Proposed New Sections 5 and 6 for
Annuity Disclosure and Sales Illustrations Model Regulation

Section 5. Standards for the Disclosure Document

A. ~~An applicant for an annuity contract shall be given both a disclosure document as described in Subsection B and the appropriate Buyer's Guide contained in Appendix A as early in the sales process as practicable. At or prior to the taking of an application for any annuity contract subject to the regulation, In all cases, the insurer, its producer or other authorized representative shall provide these documents to the applicant a disclosure document that meets the requirements of Subsection B of this section: no later than forty-eight (48) hours after an application for the contract is signed.~~

B. At a minimum, the following information shall be included in the disclosure document ~~required to be provided under this regulation:~~

- (1) The generic name of the contract, the company product name, if different, and form number, and the fact that it is an annuity;
- (2) The insurer's name and address;
- (3) A ~~plain language~~ description of all aspects of the contract and its benefits, emphasizing its long-term nature and describing in plain language, including examples where appropriate, ~~including answers to all the questions found in the appropriate Buyer's Guide.~~
 - (a) ~~The guaranteed and non-guaranteed elements of the contract, and their limitations, if any, and an explanation of how they operate;~~
 - (b) ~~An explanation of the initial crediting rate, specifying any bonus or introductory portion, the duration of the rate and the fact that rates may change from time to time and are not guaranteed;~~
 - (c) ~~Periodic income options both on a guaranteed and non-guaranteed basis;~~
 - (d) ~~Any value reductions caused by withdrawals from or surrender of the contract;~~
 - (e) ~~How values in the contract can be accessed;~~
 - (f) ~~The death benefit, if available and how it will be calculated;~~
 - (g) ~~A summary of the federal tax status of the contract and any penalties applicable on withdrawal of values from the contract;~~
 - (h) ~~Impact of any rider, such as a long-term care rider.~~

~~(4) Specific dollar amount or percentage charges and fees shall be listed with an explanation of how they apply.~~

C. ~~The disclosure document may contain the interest crediting rate that the company is currently paying in renewal years, if this rate is self-supporting as defined in Section 4P. No other non-guaranteed element may be shown to the applicant unless the applicant is given a basic illustration at the same time, shall include information about the current guaranteed rate for new policies and contain a clear notice that the rate is subject to change.~~

D. Marketing material that contains language describing ~~the~~ any non-guaranteed elements shall include with equal prominence both the negatives and positives of ~~these~~ product features.

E. ~~When the contact with a prospective insured is face to face, the disclosure shall be accompanied by the Buyer's Guide included as Appendix A, unless the prospective insured indicates he has already received a Buyer's Guide.~~

F. ~~When the contact with the prospective insured is through the Internet, the electronic interface must be designed to show the prospective insured the Buyer's Guide and make it available for downloading before the prospective insured can access an application.~~

G. ~~When the contact is through the mail or other mass marketing method where no face-to-face contact between a producer or representative of the insurer occurs, the Buyer's Guide may be delivered at the same time as the annuity contract.~~

H. ~~Where the Buyer's Guide has been delivered at or prior to solicitation, the policy shall provide for no less than a ten-day free look period. Where the prospective insured did not receive a buyer's guide until delivery of the policy, the policy shall provide for no less than a thirty-day free look period.~~

E. The minimum free-look period is determined by when both the disclosure document and Buyer's Guide are received by the applicant:

- (1) Five (5) days if both are received no later than prior to solicitation;
- (2) Ten (10) days if both are received no later than date of application; or
- (3) Thirty (30) days in all other cases.

Section 6. Contracts to be Illustrated

A. ~~An insurer or its agent or other representative is required to provide a basic illustration that meets the requirements of this regulation to the applicant for an annuity contract in each of the following situations: (1) if any non-guaranteed element is demonstrated in the disclosure materials provided shown to the applicant; The only exception is that the interest crediting rate that the company is currently paying in renewal years may be shown if it is supportable.~~

~~(2) For any policy year beyond the tenth, the amount available to the contract owner is different if the contract is surrendered for value than if it is exchanged for periodic income payments; or~~

~~(3) The annuity contract or rider being offered is an equity-indexed annuity.~~

B. If the annuity contract is being offered together with a policy or rider that provides separate life insurance protection, the rules contained in [insert state law or regulation equivalent to Life Insurance Illustrations Model Regulation] shall apply.

C. ~~A~~ basic illustration is optional for all other annuity sales presentations.

D. In the case of an equity-indexed annuity, a depiction showing product features and how it reacts to change in the market may be used instead of an illustration. The depiction shall contain the following information:

[still under development]

ATTACHMENT FOUR

Replacement Issues Working Group
Boston, Massachusetts
June 22, 1998

The Replacement Issues Working Group of the Life Insurance and Annuities (A) Committee met in Salon CD of the Marriott Copley Place Hotel in Boston, Mass., at 9 a.m. on June 22, 1998. Paul DeAngelo (N.J.) chaired the meeting. The following working group members were present: Richard Rogers (Ill.); Roger Strauss (Iowa); Lester Dunlap (La.); Cindy Martin (Mass.); Robert Commodore (Minn.); Tom Jacks (N.C.); and Joel Ario (Ore.).

1. Consider Adoption of Life Insurance and Annuities Replacements Model Regulation

Paul DeAngelo (N.J.) summarized the changes made to the Life Insurance and Annuities Replacements Model Regulation as a result of the June 17, 1998, conference call. The working group reviewed the changes as outlined by Mr. DeAngelo. He asked the working group to consider an alternative to Section 4F added by the working group at its conference call. He noted that there were a few differences in the language of that draft. The working group members suggested further modifications to the language to address concerns expressed by the audience. One of the major concerns for discussion was a recommendation from Mr. DeAngelo that Subsection C(2)(a) begin with a requirement that the insurer "independently verify" that the sales material has been left with the applicant. Marybeth Stevens (American Council of Life Insurance—ACLI) asked how this verification was to take place. Joel Ario (Ore.) said "verify" does imply more than just sending a letter. The working group decided to use a requirement in Subparagraph (a) that the insurer should "notify" the applicant by sending a letter or through verbal communication that the producer had represented all sales material, as defined, had been left with the applicant.

Ms. Stevens pointed out that the working group is considering adding this subsection to Section 4 "Duties of Producers" but this is really a duty of the company. The working group agreed that it was more appropriate to move this subsection to become Section 6C of the regulation. Ms. Stevens suggested a cross-reference in Section 4E and the working group agreed to add that. Mr. Ario moved and Robert Commodore (Minn.) seconded a motion to include the amended language in Section 6C. The motion passed.

Mr. Ario moved and Mr. Commodore seconded a motion to adopt the Life Insurance and Annuities Replacement Model Regulation as amended by the working group (Attachment Four-A). The motion passed.

2. Consider Additional Issues in Charge on Replacements

Mr. DeAngelo said the working group also had an additional charge to make recommendations to the Life Insurance and Annuities (A) Committee with regard to agents' compensation and suitability. He asked for working group input on whether and how these charges should be tackled. Mr. Ario said it was definitely important to explore suitability issues to see if they could be addressed. If not, the working group should explain why these would be difficult to address. Mr. DeAngelo noted that an additional charge is to review the Life Insurance Advertising Model Regulation. Mr. DeAngelo said he performed a review and could see the necessity to make changes. However, these were mostly in regard to the Life Insurance Illustrations Model Regulation, so he suggested this issue is more appropriately dealt with by the Life Disclosure Working Group.

Mr. DeAngelo asked whether the working group wanted to deal with the issue of agents' compensation. He said the discussion on replacements indicated the working group is convinced that the commission schedules do influence replacements. He said he would like to see incorporated into the minutes a conviction on the part of the working group that something needs to be done about the large front-end commissions. Cindy Martin (Mass.) agreed that the suitability issue definitely needs to be reviewed; however, she said that the issue of compensation is a little more complex. Mr. DeAngelo said that it is his understanding that the A Committee indicated a desire for this working group to remain intact to consider issues of suitability. He asked for a commitment from the members of the working group to remain on the group and continue the discussion and the members of the working group agreed. He suggested changing the name of the working group to the Suitability Working Group. Lester Dunlap (La.) asked how broad this review of suitability would be. He said the issue had been discussed at Annuities Working Group meetings and a particular concern about seniors was expressed. Mr. Ario suggested that the working group ask for a broad charge and perhaps a special notation for vulnerable populations. Roger Strauss (Iowa) confirmed that Commissioner Terri Vaughan (Iowa), chair of the Life Insurance and Annuities (A) Committee, is interested in a broad charge and does intend for this working group to look at both life insurance and annuities. Mr. DeAngelo said he would ask the A Committee to give a charge to the working group to look to issues of suitability in life insurance and annuities, with special attention to any vulnerable segments of the population. He also would ask that the A Committee change the name of the working group to the Suitability Working Group. Mr. Ario moved the recommendation of Mr. DeAngelo and Mr. Strauss seconded that motion. Scott Cipinko (National Alliance of Life Companies—NALC) asked what the ultimate goal of this charge would be. Mr. DeAngelo said it was not appropriate to set a goal before the working group studied the issue. He said the working group may conclude that the right end-result is the status quo. He suggested one of the first things the working group needs to do is to look at the suitability rules of the Securities and Exchange Commission (SEC). He also noted that some states, such as Minnesota, have their own suitability requirements. He said it is fortunate that Minnesota is a member of this working group. The motion to request a specific charge from the A Committee to look at suitability passed.

Mr. DeAngelo asked if it is appropriate to request a separate working group to look at the issue of agents' compensation. Mr. Ario opined that the two issues are closely related; Mr. DeAngelo responded that this is a very large undertaking for one working group. Tom Jacks (N.C.) agreed that the two issues are interrelated and suggested that they need to be discussed jointly.

3. Adopt Minutes of June 17, 1998 Conference Call

Mr. Dunlap moved and Mr. Commodore seconded a motion to adopt the minutes of the June 17, 1998, conference call of the Replacement Issues Working Group (Attachment Four-B). The motion passed.

Having no further business, the Replacement Issues Working Group adjourned at 10 a.m.

ATTACHMENT FOUR-A

Life Insurance and Annuities Replacement Model Regulation Draft June 22, 1998

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Section 1. Purpose

The purpose of this regulation is:

- A. To regulate the activities of insurers and producers with respect to the replacement of existing life insurance and annuities.
- B. To protect the interests of life insurance and annuity purchasers by establishing minimum standards of conduct to be observed in replacement or financed purchase transactions. It will:
 - (1) Assure that purchasers receive information with which a decision can be made in his or her own best interest;
 - (2) Reduce the opportunity for misrepresentation and incomplete disclosure; and
 - (3) Establish penalties for failure to comply with requirements of this regulation.

Section 2. Definitions

- A. "Direct-response solicitation" means a solicitation through a sponsoring or endorsing entity or individually solely through mails, telephone, the Internet or other mass communication media.
- B. "Existing insurer" means the insurance company whose policy or contract is or will be changed or affected in a manner described within the definition of "replacement."
- C. "Existing policy or contract" means an individual life insurance policy (policy) or annuity contract (contract) in force, including a policy under a binding or conditional receipt or a policy or contract that is within an unconditional refund period.
- D. "Financed purchase" means the purchase of a new policy ~~or contract~~ involving the actual or intended use of funds obtained by the withdrawal or surrender of, or by borrowing from the ~~policy or contract~~ values of an existing policy ~~or contract~~ to pay all or part of any premium ~~or consideration~~ due on the new policy ~~or contract~~. If a withdrawal, surrender, or borrowing involving the policy ~~or contract~~ values of an existing policy ~~or contract~~ on the life of the intended insured ~~occurs are used to pay premiums on a new policy owned by the same policyholder within thirteen (13) months before or after the effective date of the new policy or contract and is known by the replacing insurer, or if the withdrawal, surrender, or borrowing is shown on any illustration of the existing and new policies or contracts made available to the prospective policyowner by the insurer or its producers, it will be deemed prima facie evidence of a financed purchase.~~
- E. "Illustration" means a presentation or depiction that includes non-guaranteed elements of a policy of life insurance over a period of years as defined in [insert reference to state law equivalent to the NAIC Life Insurance Illustrations Model Regulation].
- F. "Policy summary," for the purposes of this regulation;
 - (1) For policies or contracts other than universal life policies, means a written statement regarding a policy or contract which shall contain to the extent applicable, but need not be limited to, the following information: current death benefit; annual contract premium; current cash surrender value; current dividend; application of current dividend; and amount of outstanding loan.
 - (2) For universal life policies, means a written statement that shall contain at least the following information: the beginning and end date of the current report period; the policy value at the end of the previous report period and at the end of the current report period; the total amounts that have been credited or debited to the policy value during the current report period, identifying each by type (e.g., interest, mortality, expense and riders); the current death benefit at the end of the current report period on each life covered by the policy; the net cash surrender value of the policy as of the end of the current report period; and the amount of outstanding loans, if any, as of the end of the current report period.
- G. "Producer," for the purpose of this regulation, shall be defined to include agents, brokers and producers.
- H. "Replacing insurer" means the insurance company that issues or proposes to issue a new policy or contract ~~and which that replaces an existing policy or contract or is a financed by an existing policy or contract purchase.~~
- I. "Registered contract" means a variable annuity contract or variable life insurance policy subject to the prospectus delivery requirements of the Securities Act of 1933.
- J. "Replacement" means a transaction in which a new policy or contract is to be purchased, and it is known or should be known to the proposing producer, or to the proposing insurer if there is no producer, that by reason of the transaction, an existing policy or contract has been or is to be:
 - (1) Lapsed, forfeited, surrendered or partially surrendered, ~~annuitized~~, assigned to the replacing insurer or otherwise terminated;

- (2) Converted to reduced paid-up insurance, continued as extended term insurance, or otherwise reduced in value by the use of nonforfeiture benefits or other policy values;
- (3) Amended so as to effect either a reduction in benefits or in the term for which coverage would otherwise remain in force or for which benefits would be paid;
- (4) Reissued with any reduction in cash value; or
- (5) Used in a financed purchase.

K. "Sales material" means a sales illustration and any other written, printed or electronically presented information created, or completed or provided by the company or producer and used in the presentation to the policy or contract owner related to the sale of the policy or contract purchased.

Section 3. Exemptions

A. Unless otherwise specifically included, this regulation shall not apply to transactions involving:

- (1) Credit life insurance;
- (2) Group life insurance or group annuities where there is no direct solicitation of individuals by an insurance producer. Direct solicitation shall not include any group meeting held by an insurance producer solely for the purpose of educating or enrolling individuals. Group life insurance or group annuity certificates marketed through direct response solicitation shall be subject to the provisions of Section 8;

Drafting Note: This exemption is intended to include group life insurance and annuities used to fund formal prepaid funeral contracts.

- (3) An application to the existing insurer that issued the existing policy or contract when a contractual change or a conversion privilege is being exercised; or, when the existing policy or contract is being replaced by the same insurer pursuant to a program filed with and approved by the commissioner;
- (4) Proposed life insurance that is to replace life insurance under a binding or conditional receipt issued by the same company;
- (5) (a) Policies or contracts used to fund (i) an employee pension or welfare benefit plan that is covered by the Employee Retirement and Income Security Act (ERISA); (ii) a plan described by Sections 401(a), 401(k) or 403(b) of the Internal Revenue Code, where the plan, for purposes of ERISA, is established or maintained by an employer; (iii) a governmental or church plan defined in Section 414, a governmental or church welfare benefit plan, or a deferred compensation plan of a state or local government or tax exempt organization under Section 457 of the Internal Revenue Code; or (iv) a nonqualified deferred compensation arrangement established or maintained by an employer or plan sponsor.

 (b) Notwithstanding Subparagraph (a), this regulation shall apply to policies or contracts used to fund any plan or arrangement that is funded solely by contributions an employee elects to make, whether on a pre-tax or after-tax basis, and where the insurance company has been notified that plan participants may choose from among two (2) or more annuity providers or policy providers and there is a direct solicitation of an individual employee by an insurance producer for the purchase of a contract or policy. As used in this subsection, direct solicitation shall not include any group meeting held by an insurance producer solely for the purpose of educating individuals about the plan or arrangement or enrolling individuals in the plan or arrangement;
- (6) Where new coverage is provided under a life insurance policy or contract and the cost is borne wholly by the insured's employer or by an association of which the insured is a member; or
- (7) Existing life insurance that is a non-convertible term life insurance policy that will expire in five (5) years or less and cannot be renewed.

B. Registered contracts shall be exempt from the requirements of Sections 6B and 7B with respect to the provision of illustrations or policy summaries; however, premium or contract contribution amounts and identification of the appropriate prospectus or offering circular shall be required instead.

Section 4. Duties of Producers

- A. A producer who initiates an application shall submit to the insurer, with or as part of the application, a statement signed by both the applicant and the producer as to whether the applicant has existing policies or contracts. If the answer is "no," the producer's duties with respect to replacement are complete.
- B. If the applicant answered "yes" to the question regarding existing coverage referred to in Subsection A, the producer shall present and read to the applicant, not later than at the time of taking the application, a notice regarding replacements in the form as described in Appendix A or other substantially similar form approved by the commissioner.

The notice shall be signed by both the applicant and the producer attesting that the notice has been read aloud by the producer ~~and left with the applicant or that the applicant did not wish the notice to be read aloud (in which case the producer need not have read the notice aloud) and left with the applicant. In either event, the notice shall be left by the producer with the applicant.~~

C. The notice shall list all life insurance policies or annuities proposed to be replaced, properly identified by name of insurer, the insured or annuitant, and policy or contract number if available; and shall include a statement as to whether each policy or contract will be replaced or whether it a policy will be used as a source of financing for the new policy or contract. If a policy or contract number has not been issued by the existing insurer, alternative identification, such as an application or receipt number, shall be listed.

D. In connection with a replacement transaction ~~The~~ the producer shall leave with the applicant at the time an application for a new policy or contract is completed the original or a copy of all sales material. With respect to electronically presented sales material, it shall be provided to the policyholder in printed form no later than at the time of policy or contract delivery.

E. Except as provided in Section 6F, in connection with a replacement transaction the producer shall submit to the insurer to which an application for a policy or contract is presented, a copy of each document required by this section, a statement identifying any preprinted or electronically presented company approved sales materials used, and copies of any individualized sales materials, including any illustrations used in the transaction.

Section 5. Duties of All Insurers that Use Producers

Each insurer shall:

A. Maintain a system of supervision and control to insure compliance with the requirements of this regulation that shall include at least the following:

- (1) Inform its producers of the requirements of this regulation and incorporate the requirements of this regulation into all relevant producer training manuals prepared by the insurer;
- (2) Provide to each producer a written statement of the company's position with respect to the acceptability of replacements providing guidance to its producer as to the ~~propriety~~appropriateness of these transactions;
- (3) A system to review the ~~propriety~~appropriateness of each replacement transaction that the producer does not indicate is in accord with Paragraph (2) above;
- (4) Procedures to confirm that the requirements of this regulation have been met; and
- (5) Procedures to detect transactions that are replacements of existing policies or contracts by the existing insurer, but that have not been identified as such by the applicant or producer.

B. Have the capacity to produce, upon request, and make available to the Insurance Department, records of each producer's:

- (1) Replacements, including financed purchases, as a percentage of the producer's total annual sales for life insurance and annuity contracts not exempted from this regulation;
- (2) Number of lapses of policies and contracts by the producer as a percentage of the producer's total annual sales for life insurance and annuity contracts not exempted from this regulation;
- (3) Number of transactions that ~~may be~~are unidentified replacements of existing policies or contracts by the existing insurer detected by the company's monitoring system as required by Subsection A(5) of this section; and
- (4) Replacements, indexed by replacing producer and existing insurer.

Drafting Note: Records required to be retained by this regulation may be maintained in paper, photograph, microprocess, magnetic, mechanical or electronic media or by any process which accurately reproduces the actual document.

C. Require with or as a part of each application for life insurance or an annuity a signed statement by both the applicant and the producer as to whether the applicant has existing policies or contracts;

D. Require with each application for life insurance or an annuity that indicates an existing policy or contract a completed notice regarding replacements as contained in Appendix A;

E. When the applicant has existing policies or contracts, retain completed and signed copies of the notice regarding replacements in its home or regional office for at least five (5) years after the termination or expiration of the proposed policy or contract;

F. When the applicant has existing policies or contracts, obtain and retain copies of any sales material as required by Section 4E, the basic illustration and any supplemental illustrations used in the sale and the producer's and applicant's signed statements with respect to financing and replacement in its home or regional office for at least five (5) years after the termination or expiration of the proposed policy or contract;

G. Ascertain that the sales material and illustrations used in the replacement meet the requirements of this regulation and are complete and accurate for the proposed policy or contract; and

H. If an application does not meet the requirements of this regulation, notify the producer and applicant and fulfill the outstanding requirements.

Section 6. Duties of Replacing Insurers that Use Producers

Where a replacement is involved in the transaction, the replacing insurer shall:

A. Verify that the required forms are received and are in compliance with this regulation;

B. ~~Notify any other existing insurer that may be affected by the proposed replacement~~ Within five (5) business days of receipt of a completed application indicating replacement or when the replacement is identified if not indicated on the application, ~~notify any other existing insurer who may be affected by the proposed replacement and within five (5) business days of a request from an existing insurer~~ mail a copy of the available illustration or policy summary for the proposed policy or available disclosure document for the proposed contract within five (5) business days of a request from an existing insurer;

C. Retain copies of the notification regarding replacement required in Section 4B, indexed by producer, in its home or regional office ~~or regional office~~ for at least five (5) years or until the next regular examination by the insurance department of a company's state of domicile, whichever is later;

D. Provide to the policy or contract owner notice of the right to return the policy or contract within thirty (30) days of the delivery of the contract and receive an unconditional full refund of all premiums or considerations paid on it, including any policy fees or charges or, in the case of a variable or market value adjustment policy or contract, a payment of the cash surrender value provided under the policy or contract plus the fees and other charges deducted from the gross premiums or considerations or imposed under such policy or contract; and

E. In transactions where the replacing insurer and the existing insurer are the same or subsidiaries or affiliates under common ownership or control Allow credit for the period of time that has elapsed under the replaced policy's or contract's incontestability and suicide period up to the face amount of the existing policy or contract. With regard to financed purchases the credit may be limited to the amount the face amount of the existing policy ~~or contract~~ is reduced by the use of existing policy ~~or contract~~ values to fund the new policy or contract. ~~This provision applies to transactions where the replacing insurer and existing insurer are the same or subsidiaries or affiliates under common ownership or control.~~

F. If an insurer prohibits the use of sales material other than that approved by the company, as an alternative to the requirements of Section 4E the insurer may:

(1) Require with each application a statement signed by the producer that:

(a) Represents that the producer used only company-approved sales material;

(b) Lists, by identifying number or other descriptive language, the sales material that was used; and

(c) States that copies of all sales material were left with the applicant in accordance with Section 4D; and

(2) Within ten (10) days of the issuance of the policy or contract:

(a) Notify the applicant by sending a letter or by verbal communication with the applicant by a person whose duties are separate from the marketing area of the insurer, that the producer has represented that copies of all sales material have been left with the applicant in accordance with Section 4D;

(b) Provide the applicant with a toll-free number to contact company personnel involved in the compliance function if such is not the case; and

(c) Stress the importance of retaining copies of the sales material for future reference; and

(3) Keep a copy of the letter or other verification in the policy file at the home or regional office for at least five (5) years after the termination or expiration of the policy or contract.

Section 7. Duties of the Existing Insurer

Where a replacement is involved in the transaction, the existing insurer shall:

A. Upon notice that its existing policy or contract may be a source of financing or replaced or a policy may be part of a financed purchase, retain copies of the notification in its home or regional office, indexed by replacing insurer, notifying it of the replacement for at least five (5) years or until the conclusion of the next regular examination conducted by the Insurance Department of its state of domicile, whichever is later.

B. ~~Within five (5) business days of receipt of a notice that an existing policy or contract is being replaced,~~ Send a letter to the policy or contract owner of the right to receive information regarding the existing policy or contract values including, if available, an in force illustration or policy summary if an in force illustration cannot be produced ~~within five (5) business days of receipt of a notice that an existing policy or contract is being replaced.~~ The information shall be provided within five (5) business days of receipt of the request from the policy or contract owner.

C. Upon receipt of a request to borrow, surrender or withdraw any policy or contract values, send to the applicant a notice, advising the policy or contract owner of the effect release of policy or contract values will have on the non-guaranteed elements, face amount or surrender value of the policy or contract from which the values are released. The notice shall be sent separate from the check if the check is sent to anyone other than the policy or contract owner. In the case of consecutive automatic premium loans or systematic withdrawals from a contract, the insurer is only required to send the notice at the time of the first loan or withdrawal.

Section 8. Duties of Insurers with Respect to Direct Response Solicitations

~~A. In order to comply with its duties regarding replacement, an insurer shall require with or as part of each completed application for life insurance or an annuity a statement as to whether the applicant has existing policies or contracts. If the answer is "no," the duties of the insurer with respect to replacement are complete.~~

~~B. In the case of an application that is initiated as a result of a direct response solicitation, if the insurer did not propose a replacement, and the applicant answered "yes" to the question in A, the insurer shall send to the applicant with the policy or contract a notice regarding replacement as described in Appendix B or other substantially similar form approved by the commissioner.~~

~~C. A. In the case of an application that is initiated as a result of a direct response solicitation, the insurer shall request from the applicant a statement asking whether a replacement is intended, require, with or as part of each completed application for a policy or contract, a statement asking whether the applicant, by applying for the proposed policy or contract, intends to replace, discontinue or change an existing policy or contract. If the applicant indicates a replacement or change is not intended or if the applicant fails to respond to the statement, the insurer shall send the applicant, with the policy or contract, a notice regarding replacement in Appendix B, or other substantially similar form approved by the commissioner.~~

~~B. If the insurer has proposed the replacement or if the applicant indicates a replacement is intended and the insurer continues with the replacement, or if the insurer has proposed the replacement, the insurer shall:~~

- ~~(1) Provide to applicants or prospective applicants with the policy or contract a notice, as described in Appendix AC, or other substantially similar form approved by the commissioner. In these instances the insurer may delete the references to the producer, including the producer's signature, without having to obtain approval of the form from the commissioner. The insurer's obligation to obtain the applicant's signature shall be satisfied if it can demonstrate that it has made a diligent effort to secure a signed copy of the notice referred to in this paragraph. The requirement to make a diligent effort shall be deemed satisfied if the insurer includes in the mailing a self-addressed postage prepaid envelope with instructions for the return of the signed notice referred to in this section; and~~
- ~~(2) Comply with the requirements of Section 6B, if the applicant furnishes the names of the existing insurers, and the requirements of Sections 6C, 6D and 6E.~~

Section 9. Violations and Penalties

A. Any failure to comply with this regulation shall be considered a violation of [cite twisting section of state's unfair trade practices act]. Examples of violations include:

- (1) Any deceptive or misleading information set forth in sales material;
- (2) Failing to ask the applicant in completing the application the pertinent questions regarding the possibility of financing or replacement;
- (3) The intentional incorrect recording of an answer;
- (4) Advising an applicant to respond negatively to any question regarding replacement in order to prevent notice to the existing insurer; or
- (5) Advising a policy or contract owner to write directly to the company in such a way as to attempt to obscure the identity of the replacing producer or company.

B. Policy and contract owners have the right to replace existing life insurance policies or annuity contracts after indicating in or as a part of applications for new coverage that replacement is not their intention; however, patterns of

such action by policy or contract owners of the same producer shall be deemed *prima facie* evidence of the producer's knowledge that replacement was intended in connection with the identified transactions, and these patterns of action shall be deemed *prima facie* evidence of the producer's intent to violate this regulation.

C. Where it is determined that the requirements of this regulation have not been met the replacing insurer shall provide to the policy owner an in force illustration if available or policy summary for the ~~proposed replacement~~ policy or available disclosure document for the ~~proposed replacement~~ contract and the notice regarding replacements in Appendix A.

D. Violations of this regulation shall subject the violators to penalties that may include the revocation or suspension of a producer's or company's license, monetary fines and the forfeiture of any commissions or compensation paid to a producer as a result of the transaction in connection with which the violations occurred. In addition, where the commissioner has determined that the violations were material to the sale, the insurer may be required to make restitution, restore policy or contract values and pay interest at [insert reference to a rate set by an applicable statute or regulation] on the amount refunded in cash.

Section 10. Severability

If any section or portion of a section of this regulation, or its applicability to any person or circumstances, is held invalid by a court, the remainder of this regulation, or the applicability of its provisions to other persons, shall not be affected.

Section 11. Effective Date

This regulation shall be effective [insert date].

APPENDIX A

IMPORTANT NOTICE:

REPLACEMENT OF LIFE INSURANCE OR ANNUITIES

This document must be signed by the applicant and the producer, if there is one, and a copy left with the applicant.

You are contemplating the purchase of a life insurance policy or annuity contract. In some cases this purchase may involve discontinuing or changing an existing policy or contract. If so, a replacement is occurring. Financed purchases are also considered replacements.

A replacement occurs when a new policy or contract is purchased and, in connection with the sale, you discontinue making premium payments on the existing policy or contract, or an existing policy or contract is surrendered, forfeited, assigned to the replacing insurer, or otherwise terminated or used in a financed purchase.

A financed purchase occurs when the purchase of a new life insurance policy ~~or annuity contract~~ involves the use of funds obtained by the withdrawal or surrender of or by borrowing some or all of the policy values, including accumulated dividends, of an existing policy ~~or contract~~, to pay all or part of any premium or payment due on the new policy. A financed purchase is a replacement.

You should carefully consider whether a replacement is in your best interests. You will pay acquisition costs and there may be surrender costs deducted from your policy or contract. You may be able to make changes to your existing policy or contract to meet your insurance needs at less cost. A financed purchase will reduce the value of your existing policy or contract and may reduce the amount paid upon the death of the insured.

We want you to understand the effects of replacements before you make your purchase decision and ask that you answer the following questions and consider the questions on the back of this form.

1. Are you considering discontinuing making premium payments, surrendering, forfeiting, assigning to the insurer, or otherwise terminating your existing policy or contract? ☐ YES ☐ NO
2. Are you considering using funds from your existing policies or contracts to pay premiums due on the new policy or contract? ☐ YES ☐ NO

If you answered "yes" to either of the above questions, list each existing policy or contract you are contemplating replacing (include the name of the insurer, the insured, and the contract number if available) and whether each policy will be replaced or used as a source of financing:

| | INSURER NAME | CONTRACT OR POLICY # | INSURED | REPLACED (R) OR FINANCING (F) |
|----|-----------------|-------------------------|---------|----------------------------------|
| 1. | | | | |
| 2. | | | | |
| 3. | | | | |

Make sure you know the facts. Contact your existing company or its agent for information about the old policy or contract. [If you request one, an in force illustration, policy summary or available disclosure documents must be sent to you by the existing insurer.] Ask for and retain all sales material used by the agent in the sales presentation. Be sure that you are making an informed decision.

The existing policy or contract is being replaced because _____

I certify that the responses herein are, to the best of my knowledge, accurate:

Applicant's Signature and Printed Name _____

_____ Date

Producer's Signature and Printed Name _____

_____ Date

I do not want this notice read aloud to me. _____ (Applicants must initial only if they do not want the notice read aloud.)

A replacement may not be in your best interest, or your decision could be a good one. You should make a careful comparison of the costs and benefits of your existing policy or contract and the proposed policy or contract. One way to do this is to ask the company or agent that sold you your existing policy or contract to provide you with information concerning your existing policy or contract. This may include an illustration of how your existing policy or contract is working now and how it would perform in the future based on certain assumptions. Illustrations should not, however, be used as a sole basis to compare policies or contracts. You should discuss the following with your agent to determine whether replacement or financing your purchase makes sense:

For Life Insurance

PREMIUMS: Are they affordable?
Could they change?
You're older—are premiums higher for the proposed new policy?
How long will you have to pay premiums on the new policy? On the old policy?

POLICY VALUES: New policies usually take longer to build cash values and to pay dividends.
Acquisition costs for the old policy may have been paid, you will incur costs for the new one.
What surrender charges do the policies have?
What expense and sales charges will you pay on the new policy?
Does the new policy provide more insurance coverage?

INSURABILITY: If your health has changed since you bought your old policy, the new one could cost you more, or you could be turned down.
You may need a medical exam for a new policy.
[Claims on most new policies for up to the first two years can be denied based on inaccurate statements.
Suicide limitations may begin anew on the new coverage.]

IF YOU ARE KEEPING THE OLD POLICY AS WELL AS THE NEW POLICY:

How are premiums for both policies being paid?
How will the premiums on your existing policy be affected?
Will a loan be deducted from death benefits?
What values from the old policy are being used to pay premiums?

IF YOU ARE SURRENDERING AN ANNUITY OR INTEREST SENSITIVE LIFE PRODUCT:

Will you pay surrender charges on your old contract?
What are the interest rate guarantees for the new contract?
Have you compared the contract charges or other policy expenses?

OTHER ISSUES TO CONSIDER FOR ALL TRANSACTIONS:

What are the tax consequences of buying the new policy?
Is this a tax free exchange? (See your tax advisor.)
Is there a benefit from favorable "grandfathered" treatment of the old policy under the federal tax code?
Will the existing insurer be willing to modify the old policy?
How does the quality and financial stability of the new company compare with your existing company?

APPENDIX B

NOTICE REGARDING REPLACEMENT REPLACING YOUR LIFE INSURANCE POLICY OR ANNUITY?

Are you thinking about buying a new life insurance policy or annuity and discontinuing or changing an existing one? If you are, your decision could be a good one—or a mistake. You will not know for sure unless you make a careful comparison of your existing benefits and the proposed policy or contract's benefits.

Make sure you understand the facts. You should ask the company or agent that sold you your existing policy or contract to give you information about it.

Hear both sides before you decide. This way you can be sure you are making a decision that is in your best interest.

APPENDIX C

IMPORTANT NOTICE: REPLACEMENT OF LIFE INSURANCE OR ANNUITIES

You are contemplating the purchase of a life insurance policy or annuity contract. In some cases this purchase may involve discontinuing or changing an existing policy or contract. If so, a replacement is occurring. Financed purchases are also considered replacements.

A replacement occurs when a new policy or contract is purchased and, in connection with the sale, you discontinue making premium payments on the existing policy or contract, or an existing policy or contract is surrendered, forfeited, assigned to the replacing insurer, or otherwise terminated or used in a financed purchase.

A financed purchase occurs when the purchase of a new life insurance policy involves the use of funds obtained by the withdrawal or surrender of or by borrowing some or all of the policy values, including accumulated dividends, of an existing policy, to pay all or part of any premium or payment due on the new policy. A financed purchase is a replacement.

You should carefully consider whether a replacement is in your best interests. You will pay acquisition costs and there may be surrender costs deducted from your policy or contract. You may be able to make changes to your existing policy or contract to meet your insurance needs at less cost. A financed purchase will reduce the value of your existing policy or contract and may reduce the amount paid upon the death of the insured.

We want you to understand the effects of replacements and ask that you answer the following questions and consider the questions on the back of this form.

1. Are you considering discontinuing making premium payments, surrendering, forfeiting, assigning to the insurer, or otherwise terminating your existing policy or contract? YES NO

2. Are you considering using funds from your existing policies or contracts to pay premiums due on the new policy or contract? YES NO

Please list each existing policy or contract you are contemplating replacing (include the name of the insurer, the insured, and the contract number if available) and whether each policy will be replaced or used as a source of financing:

| | <u>INSURER</u> <u>NAME</u> | <u>CONTRACT OR</u> <u>POLICY #</u> | <u>INSURED</u> | <u>REPLACED (R) OR</u> <u>FINANCING (F)</u> |
|-----------|-------------------------------|---------------------------------------|----------------|--|
| <u>1.</u> | | | | |
| <u>2.</u> | | | | |
| <u>3.</u> | | | | |

Make sure you know the facts. Contact your existing company or its agent for information about the old policy or contract. If you request one, an in force illustration, policy summary or available disclosure documents must be sent to you by the existing insurer. Ask for and retain all sales material used by the agent in the sales presentation. Be sure that you are making an informed decision.

I certify that the responses herein are, to the best of my knowledge, accurate:

Applicant's Signature and Printed Name _____ Date _____

A replacement may not be in your best interest, or your decision could be a good one. You should make a careful comparison of the costs and benefits of your existing policy or contract and the proposed policy or contract. One way to do this is to ask the company or agent that sold you your existing policy or contract to provide you with information concerning your existing policy or contract. This may include an illustration of how your existing policy or contract is working now and how it would perform in the future based on certain assumptions. Illustrations should not, however, be used as a sole basis to compare policies or contracts. You should discuss the following with your agent to determine whether replacement or financing your purchase makes sense:

PREMIUMS: Are they affordable?
 Could they change?
 You're older—are premiums higher for the proposed new policy?
 How long will you have to pay premiums on the new policy? On the old policy?

POLICY VALUES: New policies usually take longer to build cash values and to pay dividends.
 Acquisition costs for the old policy may have been paid, you will incur costs for the new one.

What surrender charges do the policies have?
 What expense and sales charges will you pay on the new policy?
 Does the new policy provide more insurance coverage?

INSURABILITY: If your health has changed since you bought your old policy, the new one could cost you more, or you could be turned down.
 You may need a medical exam for a new policy.
 [Claims on most new policies for up to the first two years can be denied based on inaccurate statements.
 Suicide limitations may begin anew on the new coverage.]

IF YOU ARE KEEPING THE OLD POLICY AS WELL AS THE NEW POLICY:

How are premiums for both policies being paid?
 How will the premiums on your existing policy be affected?
 Will a loan be deducted from death benefits?
 What values from the old policy are being used to pay premiums?

IF YOU ARE SURRENDERING AN ANNUITY OR INTEREST SENSITIVE LIFE PRODUCT:

Will you pay surrender charges on your old contract?
 What are the interest rate guarantees for the new contract?
 Have you compared the contract charges or other policy expenses?

OTHER ISSUES TO CONSIDER FOR ALL TRANSACTIONS:

What are the tax consequences of buying the new policy?
 Is this a tax free exchange? (See your tax advisor.)
 Is there a benefit from favorable "grandfathered" treatment of the old policy under the federal tax code?
 Will the existing insurer be willing to modify the old policy?
 How does the quality and financial stability of the new company compare with your existing company?

ATTACHMENT FOUR-B

**Replacement Issues Working Group
 Conference Call
 June 17, 1998**

The Replacement Issues Working Group of the Life Insurance and Annuities (A) Committee met by conference call at 1 p.m. on June 17, 1998. Paul DeAngelo (N.J.) chaired the meeting. The following working group members participated: Paul Hogan representing Erin Klug (Ariz.); Rosanne Mead (Iowa); Lester Dunlap (La.); Cindy Martin (Mass.); Robert Commodore (Minn.); Cindy Amann (Mo.); Adam Barclay representing Phil Bisesi (Ohio); Joel Ario (Ore.); and Ted Becker (Texas).

Paul DeAngelo (N.J.) said that the Life Insurance and Annuities (A) Committee held a conference call to consider adoption of the Life Insurance and Annuities Replacement Model Regulation. The A Committee identified a number of issues that it asked the working group to further review in light of the comments received. Mr. DeAngelo said he appreciated the comments that had been received on the specific issues and suggestions for language to correct perceived deficiencies.

1. Consider Technical Changes Suggested by the American Council of Life Insurance (ACLI)

Mr. DeAngelo said the first item that the Life Insurance and Annuities (A) Committee asked the working group to consider was incorporation of a number of technical amendments to the Life Insurance and Annuities Replacement Model Regulation from the April 20, 1998, letter from the American Council of Life Insurers (ACLI) (Attachment Four-B1). Mr. DeAngelo suggested accepting most of the recommendations but holding for consideration suggestions for Section 4E and 8C because each of these sections is a separate discussion item on the agenda. In regard to the Appendix, Mr. DeAngelo agreed that the amended heading was a good suggestion. He recommended against adoption of the suggestion in the next paragraph and declined to delete the brackets found in the insurability section. The bracketed material is there to indicate that it would appear in some presentations but not others, depending on whether there was an internal replacement. Cindy Amann (Mo.) moved and Rosanne Mead (Iowa) seconded a motion to adopt the recommendations for technical changes from the ACLI with the changes outlined by Mr. DeAngelo. The motion passed.

2. Consider the Entire Model Relative to Its Applicability to Annuities and Term Insurance

Mr. DeAngelo said he was not persuaded by the comment letters that annuities should be exempted from the model regulation. He pointed out that the existing NAIC model on replacements of life insurance and annuities have served well over the years and he thought it was important to continue that. He noted that a financed purchase cannot be made using term insurance because there is no cash value and he recommended leaving the application to term insurance as drafted. The working group members agreed with this analysis. Mr. DeAngelo recommended that the working group consider deletion of references to

annuities in the definition of financed purchase but leave the applicability of the rest of the regulation to annuities. He said he is concerned because of the increased sales of annuities and wants them to be covered in some manner. If the NAIC develops a separate model for replacements of annuities, the working group can revisit the issue and delete annuities from this model. Mr. DeAngelo asked if any of the working group members want to delete annuities from the model altogether and no regulators responded. Mr. DeAngelo recommended changes to the definition of financed purchase to delete references to annuities and pointed out the recommendations in the June 9, 1998, letter from the ACLI for corresponding changes to other sections referencing financed purchases (Attachment Four-B2). Marybeth Stevens (ACLI) pointed out that the ACLI letter also recommends changing Appendix A but Mr. DeAngelo said no language had been recommended so there was nothing for the working group to consider. Jim Mumford (Equitable of Iowa) asked if the working group would consider language at the Summer National Meeting in Boston. Mr. DeAngelo responded in the affirmative. Ms. Amann moved and Robert Commodore (Minn.) seconded a motion to incorporate the changes suggested by the ACLI relative to annuities and financed purchases, and the motion passed.

3. Determine Whether the Definition of "Financed Purchase" Should Include the Use of "Insured" or "Owner"

Mr. DeAngelo observed that the decision as to whether the insurer should be tracking the policyowner or the insured during the 13-month period before or after the effective date is a difficult issue. He noted that Section 2D as drafted in March 1998 refers to the life of the intended insured. He suggested that the draft leave out that phrase and leave it up to the states to determine if the insurance company should track the insured or the policyowner. Ms. Mead suggested adding a drafting note to alert states to this issue and offered to draft something for the working group's consideration. Interested parties expressed concern that the companies would not know whether to use "insured" or "owner" until each state acted. Joel Ario (Ore.) agreed that this created a difficulty because it meant companies would have to be prepared to go both directions. He asked the company representatives on the conference call whether any of them tracked by insured. Maureen Adolf (Prudential) said her company tracked by household. Several other participants on the call said their companies track by insured. Mr. Ario said the discrepancy between different procedures would create difficulties and moved that the model contain language that the tracking be done by the policyowner. Ms. Amann seconded the motion and it passed.

4. Clarification of the Definition of "Sales Material" and Its Use in Section 4E

Mr. DeAngelo said that New Jersey's present replacement regulation requires insurers to file all materials used in presentations with the company. This has been the rule for many years and material is reviewed by market conduct examiners. He noted, however, that comments received by the working group repeatedly mention the difficulty of maintaining sales materials at the company. Mr. DeAngelo suggested a change to the definition of sales material that would clarify that the material that should be maintained is only the material related to the policy or contract that was actually purchased. Ms. Amann said she would be more comfortable retaining the language in the draft that requires companies to keep any material related to the sale of the policy or contract purchased. She said sales material might not be directly related to the product that was ultimately purchased but could be related to the applicant's decision to go with that company. Ms. Adolf suggested changing the term "related to" to "pertaining to." Ms. Amann disagreed with that suggestion because it would not cover an article about annuities that had been shown to the applicant. Ms. Mead moved and Ms. Amann seconded a motion to delete words in the definition of sales material to read: "...used in the presentation to the policy or contract owner related to the policy or contract purchased." The motion passed.

Mr. DeAngelo outlined a suggestion for an alternative to Section 4E that would eliminate the responsibility of an insurer to store material if the company prohibited the use of anything other than company-approved sales material. Mr. Ario expressed support for the provision that Mr. DeAngelo was suggesting as Section 4F. Ms. Amann requested that a 4F(3) be added with a requirement to keep verification of the fact the letter was sent in the policy file. Ms. Adolf asked if the letter to the policyholder could be replaced, for example, with a telephone call. She said her company calls new policyholders to make sure they understand their purchase and could incorporate this information in the telephone call. Mr. DeAngelo said he would be comfortable as long as the information was verified outside the marketing situation. Ron Panneton (National Association of Life Underwriters—NALU) asked if this provision would prohibit agents from using individually prepared sales material. Mr. DeAngelo responded that, if the company approved the format of sales material which is individualized, it would be company approved sales material and section 4F could be used. Otherwise the company and agent would have to comply with the provisions of Section 4E. Todd Zomik (New York Life) asked how the company would identify to the applicant the sales material that was used, as suggested in Mr. DeAngelo's 4F. He noted that would mean that each letter would have to be individually prepared. Ms. Amann spoke in support of a requirement that the letter identify specifically sales material that the producer indicated was used in the sale. She said this is important information. Charlotte Liptak (Transamerica) reiterated the concern that it would be very difficult for a company to identify the materials in such a way that the consumer could verify which items were received. Ms. Amann said that companies should not be using that many pieces of paper. Ms. Mead opined that sending customized letters is a burden on the industry without a comparable benefit to consumers. Mr. DeAngelo agreed that identifying sales material by a code number would not mean anything to consumers. Ms. Martin suggested that preparing a customized letter would not be difficult because the information provided to the company by the agent could be incorporated in a database and that data then included in the letter to the consumer. Ms. Liptak responded that her company currently does not have the ability to mesh those two systems. Ms. Mead noted that this brought up another problem that would be considered by the working group as to the appropriate implementation date for the regulation. She said this issue was related to Ms. Liptak's comment because of the systems burden it would impose. She expressed a preference not to impose the burden so that companies could not justify a delayed implementation date.

Mr. Ario moved and Ms. Mead seconded a motion to incorporate the language suggested by Mr. DeAngelo for Section 4F with the modifications discussed during the conference call. Mr. DeAngelo explained that his suggestion that the policyholder contact the compliance department at a toll-free number did not require the letter to state that the call would go to the compliance

department. He said it was important to have a toll free number to call, and it was important that the call be routed to the compliance department; but he did not see that it was necessary for the company's letter to so state. The motion to include Mr. DeAngelo's suggested language for Section 4F passed with Missouri voting against the motion because it did not include identifying the sales material in the communication with the applicant.

5. Consider Issues Related to Direct Marketing

Mr. DeAngelo said he was favorably disposed to the suggestions made by Keith Morris (J.C. Penney Life) with regard to a revised Section 8. He said the earlier draft seemed to leave confusion as to whether a direct response company needs to send two notices. Mr. Morris' suggestion streamlines Section 8, is clearer, and eliminates duplicative notices. Ms. Mead agreed that this is a good proposal that accommodates the concerns of direct writers. Mr. Morris encouraged the working group to also consider his proposal for Appendix C. He said much of the language in Appendix A refers to producers and would be confusing in a direct response setting. Cindy Martin (Mass.) expressed support for the suggested Appendix C. Ms. Mead and Mr. Commodore also expressed support if Mr. Morris' suggestion that the questions be eliminated is not followed. Glenn Joppa (Union Fidelity Life) asked if it would be permissible to move the questions out of the notice into the application. Mr. DeAngelo said that was not a good idea. Mr. Ario moved and Mr. Commodore seconded a motion to include an Appendix C that eliminates references to an agent but maintains the questions in Appendix A and to adopt the revised Section 8. The motion passed.

6. Consider Recommendation for Effective Date of Life Insurance and Annuities Replacement Model Regulation

Mr. DeAngelo said that New Jersey may not enforce the record-keeping requirements contained in the model until the year 2001, but would impose the duties required by the rest of the regulation as soon as it was adopted. Mr. Ario suggested that the working group follow the custom in most of the NAIC models and not address the issue of an effective date. Mr. DeAngelo expressed concern that the Life Insurance and Annuities (A) Committee would make a recommendation if the working group does not. Ms. Mead confirmed that, if the working group has a preference for an effective date, it needs to communicate that to the A Committee. Mr. DeAngelo said that he feels strongly that the consumer protection portions of the model need to be implemented long before the year 2001. He suggested incorporating into the effective date section a recommendation that if a state is going to delay implementation, that should be only with respect to the record-keeping requirements of Sections 5A and B. Ms. Mead said that the A Committee will look for a recommendation from the working group, and if the working group recommends no special treatment for this model, the working group can report that to the A Committee. Mr. Ario said that the normal procedure is not to make a recommendation, so why not let each state decide if a request for a delayed effective date is persuasive. Mr. DeAngelo said he did not want to see systems requirements delay adoption of the whole model because most of the model provisions are not dependent upon Year 2000 issues. Ms. Martin moved that the working group recommend to the A Committee a delay of implementation only of Sections 5A and B, if the A Committee expresses a desire to delay implementation because of the Year 2000 issues. Mr. Commodore seconded the motion. Mr. DeAngelo clarified that specific language will not be incorporated in the model, but if the A Committee wants a recommendation, the recommendation from the working group will be to limit that delay to only Sections 5A and B. The motion passed.

Mr. Ario asked if this revised draft would now go straight to the A Committee for consideration. The working group decided to review the draft with all of the revisions agreed to during the conference call at the Summer National Meeting, adopt the draft there, and refer it to the A Committee.

Having no further business the Replacement Issues Working Group adjourned at 3:15 p.m.

ATTACHMENT FOUR-B1

April 20, 1998 Technical Comments from the American Council of Life Insurance Regarding Life Insurance and Annuities Replacement Model Regulation

Section 2. Definitions.

D. "Financed purchase." For clarity's sake, we suggest adding the words "or annuitization" to the definition of "financed purchase" after the word "borrowing" on lines 5 and 8 in order to make it consistent with Section 2J(1), defining "replacement."

H. "Replacing Insurer." For clarity's sake, delete the word "and" in the second line.

Section 4.B. For drafting clarity, we suggest moving the words "and left with the applicant" in the second sentence to the end of the sentence and to strike the last sentence, as it is unnecessary.

Section 4.C. For clarification and consistency, insert "policy or" before "contract" in the second line; insert "as to" after "statement" in the third line; insert "for the new policy or contract" after "financing" in the fourth line; and insert "policy or" before "contract" in the fourth line.

Section 4.D. For consistency's sake, add the words "In connection with a replacement transaction" at the beginning of the section. In addition, in order to clarify that sales materials need not be left if no sale is made, insert the words "at the time an application for a new policy or contract is completed" after "applicant" in the first line.

Section 4.E. In addition to our other recommended changes, for drafting clarity, we recommend deleting "each document required by this section" and inserting "the signed statement indicating whether the applicant has existing coverage and a copy of the Notice, if required."

Section 5.A.(2) and (3). To convey the intent of the sections more clearly, we suggest substituting the word "appropriateness" for "propriety."

Section 5.B. (1). "Percent" should be "percentage."

Section 5.B. (3). "maybe" should be "are."

Section 5.E. For consistency with Section 5. F., we suggest inserting the word "proposed" on the last line before "policy or contract."

Section 6.B. For grammatical consistency, we suggest moving the verb "notify" to the beginning of the first sentence.

Section 6.C. "or regional office" is repeated in the second line.

Section 6.E. For drafting clarity, we suggest moving the substance of the last sentence to the beginning of the provision by inserting the words "In transactions where the replacing insurer and the existing insurer are the same or subsidiaries or affiliates under common ownership or control," at the beginning of the section and to delete the last sentence. In addition, the word "policy" in the first line should have an "s" on it.

Section 7.B. Insert "," in the third line after "including."

Section 8.C. In order to prevent the required duplicate Notices to be provided to applicants (Appendixes A and B), we request you insert the language "in lieu of providing the applicant Appendix B as required in B., above," at the end of the fourth line after "it shall."

Section 9.C. For drafting clarity, we request that the word "replacement" be used in lieu of "proposed" in the third and fourth line of the section.

Appendix A

We suggest amending the heading in the third line to add the words ", and a copy left with the applicant."

In the paragraph following the listing of insurance products, we suggest striking the bracketed sentence and inserting the sentence "Your existing insurer will contact you and offer you information about your existing coverage." In addition, the third sentence should be amended to read "Ask for and retain all sales materials used by the producer in the sales presentation for the policy for which you are applying."

Finally, on the last page of Appendix A, we recommend deleting the caption "For life insurance" after the first paragraph and deleting the "l's" found under the "INSURABILITY" section.

ATTACHMENT FOUR-B2

June 10, 1998, Comments from the American Council of Life Insurance on the Life Insurance and Annuities Replacement Model Regulation

If annuities are not removed completely from the proposed Model Regulation, they need to be removed from the provisions relating to "financed purchase." Replacements of annuities is, in almost all cases, a complete replacement and financed purchases of annuities, as described in Section 2D, are rare. Consequently, we propose removing annuities from the following provisions relating to financed purchases:

Section 2D

"Financed purchase" means the purchase of a new policy ~~or contract~~ involving the actual or intended use of funds obtained by the withdrawal or surrender of, or by borrowing from the ~~policy or contract~~ values of an existing policy ~~or contract~~ to pay all or part of any premium ~~or consideration~~ due on the new policy ~~or contract~~. If a withdrawal, surrender or borrowing involving the ~~policy or contract~~ values of an existing policy ~~or contract~~ on the life of the intended insured occurs within thirteen (13) months before or after the effective date of the new policy ~~or contract~~ and is known by the replacing insurer, or if the withdrawal, surrender or borrowing is shown on any illustration of the existing and new policies ~~or contracts~~ made available to the prospective policyowner by the insurer or its producers, it will be deemed *prima facie* evidence of a financed purchase.

Section 2H

"Replacing insurer" means the insurance company that issues or proposes to issue a new policy or contract ~~and which replaces an existing policy or contract~~ or is a financed purchase by an existing policy or contract."

Section 2J(1)

"Replacement" means ...

(1) Lapsed, forfeited, surrendered or partially surrendered, ~~annuitized~~, assigned to the replacing insurer or otherwise terminated;.

Section 4C

The notice shall list all life insurance policies or annuities proposed to be replaced, properly identified by name of insurer, the insured or annuitant, and policy or contract number if available; and shall include a statement as to whether each policy or contract will be replaced or whether a policy it will be used as part of a financed purchase a source of financing. If a policy or contract number has not been issued by the existing insurer, alternative identification, such as an application or receipt number, shall be listed.

Section 7A

Upon notice that its existing policy or contract may be ~~a source of financing or replaced, or a policy may be part of a financed purchase~~, retain copies of the notification in its home or regional office, indexed by replacing insurer, notifying it of the replacement for at least five (5) years or until the conclusion of the next regular examination conducted by the Insurance Department of its state of domicile, whichever is later.

Appendix A

Appendix A is extremely confusing when applied to annuities. If annuities are exempted from the definition of "Financed purchase," a separate notice regarding replacement of annuities should be appended to the proposed Model Regulation. Corresponding changes would need to be made to Section 4 referencing the separate notices for life insurance and annuity replacements.

ATTACHMENT FIVE

Viatical Settlements Working Group
Boston, Massachusetts
June 22, 1998

The Viatical Settlements Working Group of the Life Insurance and Annuities (A) Committee met in Salon CD of the Marriott Copley Place Hotel in Boston, Mass., at 10 a.m. on June 22, 1998. Lester Dunlap (La.) chaired the meeting. The following working group members were present: Michael Bownes (Ala.); Linda Brunette (Alaska); Kevin McCarty (Fla.); Ron Kotowski (Ill.); Marlyn Burch (Kan.); Tom Jacks (N.C.); Tom Foley (N.D.); Dan Keating (Okla.); Joel Ario (Ore.); and Kimberly Stokes (Texas).

1. Hear Comments on Draft of Viatical Settlements Model Regulation

Lester Dunlap (La.) said it was his intention to go through the draft of the Viatical Settlements Model Regulation (Attachment Five-A) and hear comments on each section of the draft. He announced that the working group will hold an interim meeting in late July to consider how to redraft the model in response to the comments presented at the meeting. Mr. Dunlap noted that John Bragg (Bragg Associates) submitted written comments but was not in attendance. Mr. Bragg suggested adding to the end of Section 2C a phrase that said "... or as would be determined by a qualified actuary, considering available medical records and appropriate experience data applicable to disabled lives." In addition, Mr. Bragg suggested changing "making" in Section 7D to say "... in the solicitation ..." of viatical settlements. The working group considered that comment and decided that it was most appropriate to change the language to say "making or solicitation" of viatical settlements.

Mr. Dunlap asked if there were any other comments on Section 2, Definitions. Mike McNerney (Mutual Benefits Corporation), representing the Viatical Association of America (VAA), said the definition of life expectancy causes him concern because of the suggestion to determine life expectancy by a "independent medical review board." He asked if that is intended to be a governmental agency. He suggested that it is inappropriate for a governmental agency to define life expectancy to use as a criterion for pricing. He suggested that could not be done in the private sector. He said a company looks at life expectancy in many ways, including the level of care being received, the life style of the potential viator, and many other factors. He said a medical review board would not likely look at all those factors. He also noted that this is the only reference to an independent medical review board. Mr. McNerney also commented that the suggestion of Mr. Bragg to add review by an actuary is not commonly done by viatical settlement companies. He said most use a medical review, rather than an actuarial review. Mr. Dunlap asked Carolyn Johnson (NAIC/SSO) to flag the definition of life expectancy for future discussion. He also noted that the purpose of including this definition is to set some standard for reasonable payments. Mr. McNerney opined that the one who is taking the risk should make the determination. Tom Foley (N.D.) commented that this discussion is related to the working group's frustration with the marketplace determining minimum payouts. He expressed concern that companies could affect the

payouts by changing the life expectancy. He also expressed frustration with the viatical settlement industry's promise to provide pricing information, but that information is not forthcoming. Robert Shear (Accelerated Benefits Capital) said that he had been in discussions with Mark Peavy (NAIC/SSO) and promised to submit data from four companies within a day. He said in today's marketplace there are only four companies with independent financing; the rest solicit investors.

Cindy Martin (Mass.) said that legislation is pending in her state that takes a different approach. It defines "catastrophic condition" as death within 36 months. Mr. Dunlap asked Ms. Martin to provide a copy of the pending Massachusetts legislation to Ms. Johnson so that the working group could review it during the interim meeting.

Kimberly Stokes (Texas) said that an issue has come up in Texas where a provider did not renew its license. She commented that the working group should include a provision that would clarify the status of viaticated policies belonging to the company that no longer is licensed. Mr. Dunlap instructed Ms. Johnson to add the proposed Texas language to Section 3C the draft for consideration at the interim meeting. Doug Head (Medical Escrow Society) said this issue has been discussed by the viatical industry in the context of companies that go out of business.

Mr. Head also asked the working group to reconsider the requirement in Section 3B for a surety bond and in Section 3D for an errors and omissions policy. He opined that because funds are required to be kept in escrow, there is really not a need for this. He noted that this unnecessary expense raises the costs for everyone. Mr. Dunlap asked if Mr. Head knew which states' laws include the requirement for errors and omissions coverage. Mr. Head responded that only Wisconsin had such a requirement and finding a company that will write the coverage is difficult and expensive, so few brokers are licensed in Wisconsin. Mr. Head also suggested that the phrasing in Section 3E was not clear. Mr. Dunlap asked him to prepare language for the working group's consideration that he thought more clearly said what the working group intended.

Mr. Dunlap asked if there were any comments on Section 4, Appointment Requirements for Viatical Settlements and Mr. Head commented that he would prefer to see Subsection C refer to training material prepared by the viatical industry rather than the education required of an insurance agent. He said it may be appropriate to develop some basic training for viatical settlement representatives, but that would not necessarily be the same as the education required of an insurance agent or broker.

Mr. Dunlap asked if there were comments on Section 5, Standards for Evaluation of Reasonable Payments. Mr. Head asked for clarification on Section 5C and D. He noted that Subsection C indicates that the minimum payouts should not be reduced for premiums. He said he was confused by this because premiums must be taken into consideration.

Mr. Shear said the working group had yet to come to a conclusion as to the appropriate pricing in the market. He said to assume that companies use an actuarial model to determine pricing may not be an appropriate conclusion. He suggested bringing together people from various disciplines to reach a conclusion. Mr. Dunlap asked when the VAA could bring together a panel to help the working group make that decision. He agreed that a meeting would be useful but cautioned that this meeting time would need to be used to reach a firm decision because the project is to be completed by December. He suggested tying this session to the planned working group meeting at the end of July.

Ms. Stokes suggested an additional paragraph to add to the draft to allow consideration of other circumstances. She noted that the settlement might be unfair or unjust even though it fit within the criteria of the table and her suggestion would allow consideration of these additional factors. Mr. Dunlap asked her to provide more background information to the working group on this suggestion.

Tom Jacks (N.C.) said it would be helpful if the viatical industry would be prepared at the interim meeting to tell the working group whether the industry's position is that there should be *no* standards for payouts or *different* standards. He suggested the regulators needed a better sense of what the industry is seeking with more precise guidance. Mr. Head said in some areas of insurance there are powerful consumer interests represented but that is not true in the viatical settlement industry. There are a small number of viators and they are a weak voice in the halls of legislatures. He said everyone needs to be careful that viator's needs are met. He opined that they are not met by minimum payouts. Mr. Foley said that, if the industry's comment at the interim meeting is a suggestion to eliminate Section 5, then it will be up to regulators to decide on the standards.

Mr. Dunlap asked for comments on Section 6. Holly Roth (Viaticus) suggested clarifying which state's rule applies in a viatical settlement. She indicated that the letter from the Viatical Association of America also includes other suggestions for changes to Section 6.

In Section 7, Ms. Roth suggested the regulators should be careful that Subsection E does not preclude a financial planner or a doctor from suggesting a viatical settlement. She offered to develop language to clarify this provision.

Mr. Head said Subsection F should eliminate the reference to viatical settlement brokers and agents because they do not solicit investors. He said only providers solicit investors; brokers only represent the viator. Marilyn Burch (Kan.) said individuals were operating in his state as brokers and in addition soliciting investors. John Hartnedy (Ark.) said he also was aware of a person in his state who was involved on both sides of the viatical settlement. Mr. McNerney said that anyone buying a policy is, by definition, a provider and needs a provider license. The regulators decided to leave the subsection as written because it appears necessary.

Mr. Head questioned the reference to the NAIC Rules Governing the Advertising of Life Insurance in Subsection G. He said learning about the different advertising requirements of the states is too difficult a task for a small broker. He suggested leaving the "truthful and not misleading" standard. Mr. Dunlap suggested that the industry representatives draft a proposal to substitute for the reference to the NAIC rules for working group consideration.

Ms. Stokes drew the working group's attention to a proposal in the Texas comment letter to add clarification to this section where a viator retains some interest in the policy. Mr. Dunlap directed Ms. Johnson to add this provision to the draft as a new Section 7H for further consideration by the working group.

Mr. Dunlap asked for comments on Section 9. Mr. Head expressed concern with Subsection B that deals with the secondary market. He opined that most viators understand their policies are worth more if they are liquid. He suggested the viator should decide whether he wants a higher payment or whether he wants to refuse to allow the transfer of the policy. He suggested the viator should hear all of the options and make his own decision. Mr. Shear spoke in opposition to the phrase in the draft that requires a signed consent of the insured in each instance in which the information is to be divulged. He said that in a securitization a blanket consent should be allowed. Getting consent each time for each of the viatical settlements in the security would add great difficulty to a transfer. Mr. Head offered to bring language for the working group's consideration that would set out the options. Ms. Martin opined that a viatical settlement could be securitized without the patient identifying information. Mr. Shear said he can provide examples to Ms. Martin of where a potential purchaser wanted to do a medical review of the information. Mr. McNerney agreed that some of the information identified as "patient identifying information" in Section 2E would not be necessary in this type of review, and he gave the example of telephone number, facsimile number and E-mail address, but he said the broad definition would limit the types of collateralization that could occur.

Mr. McNerney opined that Section 9D allows regulators another shot at life expectancy. He said in addition to the other factors in the definition now the life expectancy had to be "realistic."

Ms. Roth said that representatives of insurers and viatical settlement providers are holding a face-to-face meeting at the Summer National Meeting and will prepare a recommendation for Section 10 at the interim meeting in July.

Ms. Roth suggested that companies already doing business when a state adopts a model act need some time to allow the state to put the regulation into place. She suggested a delayed effective date.

Ms. Stokes said that Texas has recently received several contacts from investors looking for information on viators or on viatical settlement companies. She suggested adding a provision that investors would agree not to contact the viator or further reveal names and identifying information of viators.

Mr. Dunlap commented that it would be easier for regulators if the comments from the viatical settlement industry were in the format that the NAIC uses. He asked the members of the viatical settlement industry to talk to Ms. Johnson about the NAIC's format to facilitate review of their comments. He asked them to make a separate document with their comments rather than to intermingle them within the NAIC's model document.

2. Adopt Minutes of April 10, 1998 Conference Call

Ron Kotowski (Ill.) moved and Mr. Burch seconded a motion to adopt the minutes of the April 20, 1998, conference call. The motion passed (Attachment Five-B).

Having no further business, the Viatical Settlements Working Group adjourned at 11:45 a.m.

ATTACHMENT FIVE-A

Viatical Settlements Model Regulation Draft: June 22, 1998

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Section 1. Authority

This regulation is adopted by the commissioner pursuant to the authority in Section 1 of the state statute equivalent to Section 10 of the Viatical Settlements Model Act.

Drafting Note: States considering adoption of this version of the regulation should be sure the corresponding elements contained in the current Viatical Settlements Model Act have been put in place.

Section 2. Definitions

In addition to the definitions in Section [insert reference to equivalent to Section 2 of the Viatical Settlements Model Act], the following definitions apply to this regulation:

A. "Chronically ill" means:

- (1) Being unable to perform at least two (2) activities of daily living (i.e., eating, toileting, transferring, bathing, dressing or continence);
- (2) Requiring substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment; or
- (3) Having a level of disability similar to that described in (1) above as determined by the Secretary of Health and Human Services;

B. "Insured" means the person covered under the policy being considered for viatication;

C. "Life expectancy" means the number of months the individual insured under the life insurance policy to be viaticated can be expected to live as determined by an independent medical review board considering available medical records; or as determined by a qualified actuary, considering available medical records and appropriate experience data applicable to disabled lives;

Note: The working group needs to consider this definition further.

D. "Net face amount" means the amount of the life insurance policy or certificate to be viaticated less any outstanding debts or liens;

E. "Patient identifying information" means an insured's address, telephone number, facsimile number, electronic mail address, photograph or likeness, employer, employment status, social security number, or any other information that is likely to lead to the identification of the insured; and

F. "Terminally ill" means having an illness or sickness that can reasonably be expected to result in death in twenty-four (24) months or less.

Section 3. License Requirements for Viatical Settlement Providers

A viatical settlement provider, as defined in [insert reference to Section 2 of Viatical Settlement Act], shall not enter into or solicit a viatical settlement contract without first obtaining a license from the commissioner.

Drafting Note: States should consider including an effective date three to four months in the future, to allow existing companies to continue operation while licensing requirements are being implemented.

A. The application shall be on a form required by the commissioner.

B. Only those individuals named in the application may act as viatical settlement providers.

GA. In addition to the information required in Section [insert reference to state law equivalent to Section 3 of the Viatical Settlements Model Act], the commissioner may ask for such additional other information as is necessary to determine whether the applicant for a license as a viatical settlement provider, viatical settlement broker or viatical settlement representative complies with the requirements of Section [insert reference to state law equivalent to Section 3 of Viatical Settlements Model Act].

DB. A viatical settlement providers shall acquire and maintain a surety in the amount of \$[insert amount]. A copy of the executed bond shall be filed with the commissioner at the time of application for a license.

Section 2. License Requirements for Viatical Settlement Brokers

A viatical settlement broker shall not solicit a viatical settlement contract without first obtaining a license from the commissioner.

A. A viatical settlement broker shall make application on a form required by the commissioner.

C. The application shall be accompanied by a fee of \$[insert amount]. The license may be renewed yearly by payment of a fee of \$[insert amount], the statistical data and a recent copy of a letter of good standing obtained from the filing officer of the applicant's state of domicile. If a viatical settlement provider, viatical settlement broker or viatical settlement

~~representative fails~~ Failure to pay the renewal fee within the time prescribed, ~~such nonpayment~~ shall result in automatic revocation of the license. ~~If a viatical settlement provider has, at the time of renewal, viatical settlements that have not matured, it shall do one of the following:~~

(1) Renew or maintain its current license status until the earlier of the following events:

(a) The date the viatical settlement provider properly assigns, sells or otherwise transfers the viatical settlements that have not matured; or

(b) The date that the last viatical settlement transaction has matured.

(2) Appoint, in writing, either the viatical settlement provider that entered into the viatical settlement, the broker who received commissions from the viatical settlement, if applicable, or any other viatical settlement provider or broker licensed in this state to make all inquiries to the viator, or the viator's designee, regarding health status of the viator or any other matters.

Drafting Note: If fees are covered in state law or a comprehensive fee regulation, delete reference to fees in Subsection C.

~~ED.~~ A viatical settlement broker shall acquire and maintain an errors and omissions policy in an amount commensurate with the broker's exposure, satisfactory to the insurance commissioner.

~~EE.~~ The license issued to a viatical settlement provider, viatical settlement broker or viatical settlement representative shall be a limited license ~~which that~~ allows solicitation only of viatical settlements.

~~DE.~~ Prelicensing education and continuing education required of ~~other insurance~~ agents and brokers in Section [insert section] shall ~~not~~ apply to viatical settlement brokers and representatives.

Drafting Note: Delete Subsection DE if the state does not require prelicensing and continuing education.

~~F.~~ The commissioner shall have the right to suspend, revoke or refuse to renew the license of any viatical settlement broker if the commissioner finds that:

~~(1) There was any misrepresentation in the application for a license;~~

~~(2) The broker has been found guilty of fraudulent or dishonest practices, has been found guilty of a felony or any misdemeanor of which criminal fraud is an element, or is otherwise shown to be untrustworthy or incompetent;~~

~~(3) The licensee has placed or attempted to place a viatical settlement with a viatical settlement provider not licensed in this state; or~~

~~(4) The licensee has violated any of the provisions of [insert citation to the Viatical Settlement Act] or this regulation.~~

~~G.~~ Before the commissioner shall deny a license application or suspend, revoke or fail to renew the license of a viatical settlement broker, the commissioner shall conduct a hearing in accordance with ~~the state's administrative procedure act~~.

~~Section 3. Other Requirements for Brokers~~

~~A.~~ In the absence of a written agreement making the broker the viator's agent, ~~viatical settlement brokers shall be presumed to be agents of viatical settlement providers.~~

~~Section 4. Appointment Requirements for Viatical Settlement Representatives~~

A viatical settlement representative, as defined in [insert reference to Section 2 of Viatical Settlement Act], shall not solicit a viatical settlement contract without first obtaining an appointment from a licensed viatical settlement provider or viatical settlement broker.

A. The appointment shall be made on a form required by the commissioner.

B. The appointment shall be accompanied by a fee of \$[insert amount]. The appointment may be renewed yearly by payment of a fee of \$[insert amount]. Failure to pay the renewal fee within the time prescribed may result in automatic expiration of the appointment.

C. Prelicensing education and continuing education required of insurance agents and brokers in Section [insert section] also shall apply to viatical settlement representatives.

Drafting Note: Delete Subsection C if the state does not require prelicensing and continuing education.

D. If such appointment is revoked by either party, the Commissioner shall be notified of such revocation within 30 days by the appointing Viatical Settlement Provider or Viatical Settlement Broker.

Section 45. Standards for Evaluation of Reasonable Payments

~~In order to assure that viators receive a reasonable return for viaticating an insurance policy, the following shall be minimum discounts:~~

A. The return for viaticating a life insurance policy or certificate shall be no less than the following payouts:

| Insured's Life Expectancy | Minimum Percentage of Net Face Value Amount |
|-------------------------------------|--|
| | Less Outstanding Loans Received by Viator |
| Less than 6 months | [8085%] |
| At least 6 but less than 12 months | [7078%] |
| At least 12 but less than 18 months | [6570%] |
| At least 18 but less than 24 months | [60%] |
| Twenty-four months or more | [50%] |

Drafting Note: The federal Health Insurance Portability and Accountability Act of 1996 spoke of the possibility of the NAIC developing separate minimum payouts for the chronically ill. The Viatical Settlement Working Group recommends this table serve that purpose also, so that chronically ill would receive a minimum payout of 50%. The percentage may be reduced by [5%] for viaticating a policy written by an insurer rated less than the highest [4] categories by A.M. Best, or a comparable rating by another rating agency.

B. A Viatical settlement brokers shall not, without the written agreement of the viator obtained prior to performing any services in connection with a viatical settlement, seek or obtain any compensation from the viator.

C. The minimum payout may not be reduced by the minimum premium required to keep the policy in force for the duration of the estimated life expectancy of the insured.

D. If no future premium is due on the policy (i.e., paid up policy, disability waiver), the minimum amounts in Subsection A shall be increased by three percent (3%).

Section 56. Reporting Requirement

On March 1 of each calendar year, each viatical settlement provider licensed in this state shall make a report, by state of domicile of the viator and in the aggregate, containing the following information for the previous calendar year all active viatical settlement contracts:

A. For each policy viaticated:

- (1) Date viatical settlement entered into;
- (2) State where viatical settlement took place;
- (23) Life expectancy of ~~viator~~the insured at time of contract;
- (34) Face amount of policy;
- (45) Amount paid by the viatical settlement provider to viaticate the policy; and
- (56) If the ~~viator~~insured has died:

(a) Date of death; and

(b) Amount of time that passed after the date of contract; and

(b)(c) Total insurance premiums paid by viatical settlement provider to maintain the policy in force;

B. Breakdown Report of applications received, accepted and rejected, by disease category;

C. Breakdown Report of policies viaticated by issuer and policy type;

D. Number of secondary market vs. primary market transactions;

E. Portfolio size Aggregate amount of viaticated policies; and

F. Amount of outside borrowings Report of funding sources.

Section 67. General Rules

A. With respect to policies containing a provision for double or additional indemnity for accidental death, the additional payment shall remain payable to the beneficiary last named by the viator prior to entering into the viatical settlement agreement~~contract~~, or to such other beneficiary, other than the viatical settlement provider, as the viator may thereafter designate, or in the absence of a designation~~beneficiary~~, to the estate of the viator.

B. Payment of the proceeds of a viatical settlement pursuant to [insert citation for Section 9D of Viatical Settlements Model Act] shall be by means of wire transfer to the account of the viator or by certified check.

C. Payment of the proceeds to the viator pursuant to a viatical settlement shall be made in a lump sum ~~Retention of a portion of the proceeds by the viatical settlement provider or escrow agent is not permissible except where. Installment payments shall not be made unless the viatical settlement company~~ provider has purchased an annuity or similar financial instrument issued by a licensed insurance company or bank, or an affiliate of either. Retention of a portion of the proceeds by the viatical settlement provider or escrow agent is not permissible.

D. A viatical settlement provider, ~~viatical settlement or broker or viatical settlement representative~~ shall not discriminate in the making or solicitation of viatical settlements on the basis of race, age, sex, national origin, creed, religion, occupation, marital or family status or sexual orientation, or discriminate between viators with dependents and without.

E. A viatical settlement provider, ~~or viatical settlement broker or viatical settlement representative~~ shall not pay or offer to pay any finder's fee, commission or other compensation to any ~~viator's insured's~~ physician, or to an attorney, accountant or other person providing medical, legal or financial planning services to the viator, or to any other person acting as an agent of the viator with respect to the viatical settlement.

~~F. Contacts for the purpose of determining the health status of the viator by the viatical settlement provider or broker after the viatical settlement has occurred should be limited to once every three (3) months for viators with a life expectancy of more than one year, and to no more than one per month for viators with a life expectancy of one year or less. The provider or broker shall explain the procedure for these contacts at the time the viatical settlement contract is entered into.~~

~~GF. A Viatical settlement providers, viatical settlement and brokers or viatical settlement agent shall not solicit investors who could influence the treatment of the illness of the viators insured whose coverage would be the subject of the investment.~~

~~HG. Advertising standards: The standards related to advertising found in Section [insert reference to state statute equivalent to the NAIC Rules Governing the Advertising of Life Insurance] applicable to viatical settlements shall be followed. In addition:~~

~~(1) Advertising should be truthful and not misleading by fact or implication.~~

~~(2)(1) If the advertiser emphasizes the speed with which the viatication will occur, the advertising must disclose the average time frame from completed application to the date of offer and from acceptance of the offer to receipt of the funds by the viator.~~

~~(2)(2) If the advertising emphasizes the dollar amounts available to viators, the advertising shall disclose the average purchase price as a percent of face value obtained by viators contracting with the advertiser during the past six (6) months.~~

~~H. If a viatical settlement provider enters into a viatical settlement that allows the viator to retain an interest in the policy, the viatical settlement contract shall contain the following provisions:~~

~~(1) A provision that the viatical settlement provider will effect the transfer of the amount of the death benefit only to the extent or portion of the amount viaticated. Benefits in excess of the amount viaticated shall be paid directly to the viator's beneficiary by the insurance company;~~

~~(2) A provision that the viatical settlement provider will, upon acknowledgment of the perfection of the transfer, either:~~

~~(a) Advise the insured, in writing, that the insurance company has confirmed the viator's interest in the policy; or~~

~~(b) Send a copy of the instrument sent from the insurance company to the viatical settlement company that acknowledges the viator's interest in the policy; and~~

~~(3) A provision that apportions the premiums to be paid by the viatical settlement company and the viator. It is permissible for the viatical settlement contract to specify that all premiums shall be paid by the viatical settlement company. The contract may also require that the viator reimburse the viatical settlement provider for the premiums attributable to the retained interest.~~

Section 8. Disclosure

A disclosure document containing the disclosures required in insert reference to state law enacting Viatical Settlements Model Act1 and this regulation shall be provided before or concurrent with the signing of the viatical settlement contract.

Section 9. Prohibited Practices

A. A viatical settlement provider, viatical settlement broker or viatical settlement representative shall not provide patient identifying information to any person, unless the insured and viator provide informed, written consent to the release of the information.

B. A viatical settlement provider, viatical settlement broker or viatical settlement representative shall obtain from a person that is provided with patient identifying information a signed affirmation that the person or entity will not further divulge the information without procuring the express, written consent of the insured in each instance in which the information is to be divulged. Notwithstanding the foregoing, if a viatical settlement provider, viatical settlement broker or viatical settlement representative is served with a subpoena and, therefore, compelled to produce records containing patient identifying information, it shall notify the viator and the insured within five (5) business days after receiving notice of the subpoena.

C. A viatical settlement provider shall not act also as a broker, whether entitled to collect a fee directly or indirectly, in the same viatical settlement or viatical loan agreement.

D. A viatical settlement provider shall not use a longer life expectancy than is realistic in order to reduce the minimum payout to which the viator is entitled.

Drafting Note: Market conduct examiners should review annual reports closely to detect a pattern of abuse in artificially raising the life expectancy.

Section 10. Insurance Company Practices

[content will be drafted after recommendation from technical resource advisors]

Section 11. Effective Date

This regulation is effective [insert date].

ATTACHMENT FIVE-B

Viatical Settlements Working Group
Conference Call
April 30, 1998

The Viatical Settlements Working Group of the Life Insurance and Annuities (A) Committee met by conference call at 1 p.m. on April 30, 1998. Lester Dunlap (La.) chaired the meeting. The following working group members participated: Elizabeth Bookwalter representing Michael Bownes (Ala.); Frank Dino representing Kevin McCarty (Fla.); Ron Kotowski (Ill.); Marlyn Burch (Kan.); Rebecca Hill representing Tom Jacks (N.C.); Tom Foley (N.D.); Dan Keating (Okla.); and Jan Gibson representing Rhonda Myron (Texas).

Tom Foley (N.D.) reviewed the provisions of Section 5 (Standards for Evaluation of Reasonable Payments) in the April 23, 1998, draft of the Viatical Settlements Model Regulation. Mr. Foley noted that the minimum percentages had been increased over those in the existing model regulation. Mr. Foley also noted that some consideration had been given to inserting language to address the problem of companies knowingly assigning viators to an inappropriate life expectancy bracket, but it had been decided not to insert language at this point.

Doug Head (Medical Escrow Society) asked why the regulators are concerned with minimum payouts. Mr. Head said "we are getting pressure in many states on how to get minimum returns for investors, so we are getting crossfire here." Mr. Foley said that viators are at extremely vulnerable stages in their lives, and therefore need protection. Mr. Head responded by saying that the marketplace is competitive, and that payouts on the shorter duration life expectancies have risen as a result of competition.

Mr. Foley asked if it is possible for industry to develop "participating" policies, i.e., policies which vary the payout depending upon how long the viator actually lives. Robert Shear (Accelerated Benefits Capital), representing the Viatical Association of America (VAA), stated that while participating policies might work in theory, in practice it would be difficult to implement the concept. He said "to the extent that one is participating in the areas which have the least probability for determining life expectancy, which is clearly the longer term, and the pricing gets very narrow at the short end, there isn't really the opportunity to balance out both ends of the spectrum." Mr. Shear also said that, to the best of his knowledge, it costs the highest volume producer about 4% of the face amount to originate any one policy in a given year. He added that most producers incur

costs of between 5% and 7%, and he said that he did not believe those costs had been factored into the minimum percentages in the model.

A lengthy discussion then ensued regarding what sort of actuarial study should be performed to determine appropriate minimum payouts. Jack Bragg (John M. Bragg & Associates) stated that a key component of any logical approach to estimating life expectancies would be the development of factors for specific medical conditions to apply to standard mortality tables. Mr. Bragg stated that the proper amount for the viatical settlement is "not a disabled life cash value, and it's possible there is existing actuarial theory in place to work such things." Mr. Shear noted that, given the relative small numbers of viators and the unique and somewhat intangible circumstances (e.g., emotions, financial constraints) of each viator, he would describe the process of estimating life expectancies as "clinical and specific to each case" as opposed to a standardized "scientific" approach.

A general discussion then ensued regarding what sort of actuarial study, if any, will be undertaken. At the end of that discussion, Mr. Shear said that "the industry will, over the next 31 days until the end of May, pool its resources" and viatical settlement providers "who have been around for a while can get you enough information to at least do the exercise." Mr. Shear said that the industry may "come out of that exercise questioning whether setting of prices is the right course or not." Mr. Foley asked that any information that is gathered be sent to Mark Peavy (NAIC/SSO).

Lester Dunlap (La.) stated that, relative to both actuarial and non-actuarial issues, the primary focus of the regulators should be to protect consumers. Mr. Shear said that in the industry's 10-year existence, he was aware of only one episode in which significant complaints had been raised relative to the amounts paid viators. Also, Mr. Dunlap asked that comments relative to the April 23, 1998, draft of the Viatical Settlements Model Regulation be submitted as quickly as possible.

Having no further business, the Viatical Settlements Working Group adjourned at 1:45 p.m.

ATTACHMENT SIX

Life Insurance and Annuities (A) Committee Conference Call May 28, 1998

The Life Insurance and Annuities (A) Committee met by conference call at 1 p.m. on May 28, 1998. A quorum was present and Terri Vaughan (Iowa) chaired the meeting. The following committee members or their representatives participated: Linda Connolly representing Neil D. Levin, Vice Chair, (N.Y.); Lee McClellan representing Patrick E. Kelly (D.C.); Lester Dunlap representing James H. Brown (La.); Cindy Martin representing Linda Ruthardt (Mass.); Frank Cote representing Mark O'Keefe (Mont.); and Dan Keating representing John Crawford (Okla.).

Commissioner Terri Vaughan (Iowa) began the call by asking if there were particular issues regulators wished to raise relative to the Life Insurance and Annuities Replacement Model Regulation. Paul DeAngelo (N.J.) noted that in Section 6C, the reference should be to Section 6B instead of Section 4B.

Commissioner Vaughan then presented her thoughts on the main points made in the comment letters. First, she said there were a number of suggestions for technical changes. In particular, she noted that there were a number of suggested language changes in Section 8. Mr. DeAngelo said he had no objection to accepting the technical changes recommended by the American Council of Life Insurance (ACLI), with the exception of the change in the Appendix A immediately preceding the signatures. Next, a discussion occurred relative to the inclusion of annuities within the scope of the model. Cynthia Martin (Mass.) noted that annuities are included in the existing Replacement of Life Insurance and Annuities Model Regulation. She further stated that it is important to provide consumers with these protections during an annuity's accumulation phase. Commissioner Vaughan said that she was somewhat sympathetic to the arguments that it would be unduly burdensome to apply a 13-month "look back" and "look forward" to annuities. Jim Mumford (Equitable of Iowa) stated that there are few financed purchases involving annuities, and suggested that annuities be excluded from the definition of "financed purchase." Commissioner Vaughan and Mr. DeAngelo agreed that it would be reasonable to exclude annuities from the provisions of Section 2D. Further, Commissioner Vaughan said that it would be helpful for the Replacements Issues Working Group, prior to the Summer National Meeting in Boston, to hold a conference call to discuss whether annuities should be excluded from other portions of the model. Mr. DeAngelo agreed with that suggestion, but he added that the working group had not received a lot of input from the industry relative to the appropriate handling of annuities. Commissioner Vaughan asked the industry to provide regulatory language for any problems that they identify. Mr. DeAngelo asked that comments be provided by June 10; this would permit them to be distributed in time for a call on June 17.

Next, a discussion occurred regarding whether the phrase "contract on the life of the intended insured" should be replaced by a phrase such as "contract owned by the same policyholder." Mr. DeAngelo said he favors such a change. Also, a lengthy discussion ensued regarding the difficulty of creating systems to implement the 13-month "look back" and "look forward" provisions. At the end of that discussion, Commissioner Vaughan stated that more discussion is needed on the issue of "insured" vs. "owner," as well as more information regarding the systems cost that will be incurred. During the discussion, it was also noted that the definition of "replacement" does not clearly specify whether it is based on transactions relative to an "insured" or "owner."

Next, a lengthy discussion occurred relative to the collecting of sales material. Commissioner Vaughan asked if the purpose of this provision is to catch agents who use inappropriate sales material. Mr. DeAngelo said that was part of the reason; he also

stated another purpose was to give regulators and companies the ability to effectively respond to complaints that are raised subsequent to the sale. Several industry representatives expressed concerns as to whether they would be able to physically manage such a large volume of paper. Also, it was stated that the definition of "sales material" is extremely broad and that this would add to the difficulties in collecting the material. Mr. DeAngelo responded that the definition of "sales material" had been significantly narrowed during the development of the model, pursuant to industry's previous comments. He said that he did not know what more could reasonably be done. During the discussion, it was suggested that the phrase "including any illustrations used in the transaction" be eliminated from Section 4E, since the term "sales material" already encompasses illustrations related to the purchased policy or contract. It was also suggested that the industry representatives should develop a drafting note that clarifies the scope of the term "sales material."

Next, various industry representatives offered additional comments. Several individuals repeated the previously expressed concerns regarding 1) what they perceived to be ambiguities in the definition of "sales material" and 2) the applicability of the model to annuities. Maureen Adolf (Prudential) expressed a concern relative to the difficulties in complying with the requirement to notify an applicant of the effect the release of policy or contract values will have on the non-guaranteed elements (Section 7C). Barb Secor (Cuna Mutual) asked if term insurance could be excluded in a manner similar to annuities. After a brief discussion, Commissioner Vaughan asked the Replacement Issues Working Group to confirm that term insurance is not included within the scope of "financed purchase." Ms. Secor also said her company had concerns relative to imposing these requirements on the direct response market. Specifically, a discussion ensued regarding whether a provision should be added to the model that makes clear that insurers are under no obligation to replace a policy. Also, a discussion occurred regarding the obligations of direct response writers who do not issue replacement coverage. Commissioner Vaughan invited industry representatives to submit written comments with clarifying language relative to that issue.

Next, Bill Geiger (Western Reserve & Aegon Ins. Group) expressed a concern that "much of the notification and other requirements are triggered off the mere existence of other coverage, not necessarily an actual attempt to replace." He also stated the definition of "financed purchase" should be modified to only include transactions involving at least 25% of the cash value. He said the "25%" is in the existing NAIC model. Mr. DeAngelo responded by saying that these issues had been discussed early in the development process, and that the decisions made by the working group were consistent with the approaches the states themselves are taking. He also noted that many financed purchases begin with the use of minimal policy values and progress to more substantial values.

In summary, Commissioner Vaughan stated that the Replacement Issues Working Group will review the following items:

- 1) Technical changes suggested by the ACLI;
- 2) The entire model relative to its applicability to annuities and term insurance (particularly the definition of "financed purchase");
- 3) The definition of "financed purchase" to determine whether use of "insured" or "owner" is appropriate (or, more generally, what concept should be encompassed by the term "replacement");
- 4) Clarification of the definition of "sales material" and its use in Section 4E; and
- 5) Confirm that Section 8C(2) accomplishes its intended purpose.

Commissioner Vaughan repeated that the working group conference call will be held June 17 and comments are due by June 10.

Next, Commissioner Vaughan addressed the effective date issue. She said that she personally is hesitant to place any new systems burdens on companies, given the Year 2000 problem. She said that both the working group and the A Committee need to give serious consideration to delaying the effective date of the "look back" and "look forward" provisions. She also said that comments should be submitted relative to any "effective date" issues that exist regarding any section of the model. Commissioner Vaughan also stated that, with the possible exception of the issue of a company's right not to replace coverage, comments should be restricted to those issues that she explicitly listed.

Ms. Martin moved and Lester Dunlap (La.) seconded a motion to send the Life Insurance and Annuities Replacement Model Regulation back to the Replacement Issues Working Group for further review pursuant to the above specifications. The motion passed unanimously.

Having no further business, the Life Insurance and Annuities (A) Committee adjourned at 2:20 p.m.