LIFE INSURANCE (C3) SUBCOMMITTEE

Reference:
1974 Proc. Vol. I p. 439
1974 Proc. Vol. II p. 518

Hon. Dick L. Rottman, Chairman – Nevada
Hon. Stanley C. DuRose, Vice-Chairman – Wisconsin

AGENDA

1. Report of the Task Force on Policy Lapsation.
2. Report on the Task Force on Agents' Compensation.
3. Report on the Task Force to Study Reinsurance Activities.
4. Report on the Task Force to Study Standard Non-Forfeiture and Reserve Valuation Laws.
5. Report on the Life Insurance Cost Comparison Task Force.
6. Discussion on Policy Loan Interest Rates.
7. Discussion on Annual Pure Endowment Contracts.
8. Any other matters brought before the Subcommittee.

The Life Insurance (C3) Subcommittee was called to order in the Arco-Iris Room of the Camino Real Hotel in Mexico City on Tuesday, December 4, 1974, at 9:00 a.m. A quorum was present and the meeting was chaired by Stanley C' DuRose, Vice-Chairman, in the absence of Chariman Rottman.

Commissioner Barnes, Chairman of the Policy Lapsation Task Force, reported on the work of the task force. In executive session the Subcommittee adopted the task force report and voted to discharge it with thanks and appreciation for the work that has been done (report attached).

The report of the Life Insurance Agents' Compensation Task Force was given by Mr. William E. Tipton chairman of the industry advisory committee, on behalf of Commissioner Farmer, chairman of the task force. The task force is making substantial progress on an in-depth study of all of the various facets of the existing agents' compensation systems. The report of the task force was adopted in executive session and is attached.

The Life Reinsurance Task Force did not submit a report and in executive session the Subcommittee voted to continue the task force in existence subject to direction by the Chairman of the Life Insurance (C3) Subcommittee.

Mr. John Montgomery, Chairman of the Task Force to Study the Standard Non-Forfeiture and Reserve Valuation Laws, gave a detailed report of the activities of that task force. The report outlines the work of the task force and specifically describes how it intends to proceed with its work. The task force recommends that it should be reorganized as a technical subcommittee of the Life Insurance (C3) Subcommittee in a manner similar to the Technical Subcommittees reporting to the Blanks (A1) Subcommittee. In executive session the report of the task force was adopted, including its recommendations (report attached).

The Chairman of the Life Insurance Cost Comparison Task Force presented its report as adopted after its Mexico City meeting held earlier in the week. The report was adopted in executive session and is attached.

The next item under the agenda was a discussion of the matter of policy loan interest rates. Mr. George Hardy, Northwestern Mutual Life Insurance Company, reported on efforts to enact the 1973 NAIC's Variable Policy Loan Interest Rates Model Act. He explained that the problems associated with policy loan interest rates were not temporary problems but were long-range problems. He stated that there will be strong efforts in 1975 to enact legislation in the 24 states where such legislation would be appropriate. There are 26 states where legislation is not needed. There was substantial discussion of the various matters associated with policy loan interest rates.

Mr. W. Keith Sloan, Actuary for the Arkansas Department, presented a statement identifying problems associated with special endowment policies or other policy forms which will frequently contain an endorsement, rider or side-fund, and which frequently are improperly sold to the public. The statement by Mr. Sloan is attached to this report. In executive session the subcommittee voted to establish a task force to identify the particular types of policy forms involving the problems discussed by Mr. Sloan. To the extent possible it is to identify the applicable statutes and procedures that could be used to properly regulate the sales of such products. This Task Force should coordinate its work with that of the Task Force studying Standard Non-Forfeiture Laws to the extent that its work may involve matters associated with the Standard Valuation and Non-Forfeiture Laws.*

With no further business to come before the Subcommittee, the meeting was adjourned.

Hon. Dick L. Rottman, Chairman, Nevada; Hon. Stanley C. DuRose, Vice-Chairman, Wisconsin; Hon. John G. Bookout, Alabama; Hon. Ark Monroe III, Arkansas; Hon. J. Richard Barnes, Colorado; Hon. Maximilian Wallach, D. C.; Hon. William H. Huff III, Iowa; Hon. John G. Ryan, Massachusetts; Hon. Evelyn Gandy, Mississippi; Hon. James J. Sheeran, New Jersey; Hon. Lester L. Rawls, Oregon.

**This sentence was amended by the (C) Committee to read "to the extent that all matters concerning that subject should be referred to the Study Task Force." See p. 573.*

Life Insurance Policy Lapsation (C3) Task Force

Mexico City, Mexico
December 2, 1974

The Task Force to study Life Insurance Policy Lapsation met in the Jardin Room at 1:00 p.m. December 2, 1974.

Four members of the task force, or their representatives, were present. Helen T. Noniewicz, Director of Market Surveys, Research Division of LIMRA, summarized the many studies, their recommendations, and various persistency materials prepared by LIMRA. She indicated that their studies definitely show lapses to be cyclical.Presently they are on the downtrend. There is a relationship between the product, the buyer, and the agent - each has an effect on lapses. As recruiting activity drops off, lapses in any given company go down. Policy loans will result in lapsation during later policy years.

One of those in attendance indicated that a suitability regulation which would apply at the time of sale may be of some assistance.

Manual Cueto of the New York Department reminded us of the fact that changing economic conditions, over which insurance regulators and industry have no control, have a serious impact on later-year lapsation.

Prof. Jack Manders of Drake University indicated that their study center on insurance was available if needed for research projects.

In Executive Session it was concluded that there is very little of a definitive nature which the regulators can do that has a direct impact on lapse control. However, there are many things which have an indirect effect. For example the work of the Task Force on Life Insurance Advertising has a definite indirect impact on improved persistency. The raising of agent qualifications standards – through the NAIC's Uniform Agents and Brokers Licencing Law, and through the work of the (B2) Subcommittee on uniform agent licensing examinations -- likewise can have an indirect effect. States which have not promulgated the NAIC's Model Replacement Regulation are encouraged to do so because of its favorable effect on the lapse picture.

The task force expressed concern that if companies are offering specially designed policies for specific markets, they may leave a gap which could result in Federal intervention to provide for the needs of people who otherwise are not being sold insurance. This gap would result from companys' eliminating policies with higher lapse potential and thus removing certain products from the market. These are normally policies bought by those individuals more prone to lapse.

Hon. J. Richard Barnes, Chairman, Colorado.

Agents Compensation (C3) Task Force
Mexico City, Mexico
December 2, 1974

Following the June 1974 NAIC meeting in San Francisco, the chairman appointed an industry advisory committee to approach the questions listed in the task force's June report. The industry committee has been extremely active and its report is attached. It contains a chart in outline-form of the elements of an agent's compensation for each of the various types of agents. The chart is followed by a schedule listing the detailed information given in the format of the chart. There is also a schedule showing typical industry amounts.

Substantial progress has been made and it is recommended that this Task Force continue in existence to complete its study. The Task Force intends to hold its next meeting on April 27, 1975, in New Orleans in conjunction with the Zone III meeting.

Hon. Edward G. Farmer Jr., Chairman, Missouri.

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LIFE AGENTS' COMPENSATION (C3) INDUSTRY ADVISORY COMMITTEE
Mexico City, Mexico
December 3, 1974

The industry committee met in Kansas City, Missouri, on September 4, 1974, with the following present:

William E. Tipton, Kansas City Life, Chairman
W. L. Balliu, Farmland Insurance Company
Richard E. Bex, Continental Assurance Company
James S. Brock, National Life Insurance Company
Allen Crouch, Penn Mutual Life Insurance Company
Ronald J. Doane, The Equitable Life Assurance Society of the United States
S. C. DuRose, Commissioner of Insurance Wisconsin
Ramon Estefania, South Carolina Insurance Department
Edward G. Farmer, Jr., Director of Insurance Missouri
Robert R. Googins, Connecticut Mutual Life Insurance Co.
James D. Huber, Insurance Department Illinois
Richard F. Keathley, Commissioner of Insurance Tennessee
James V. LeLaurin, CLU, Aetna Life & Casualty
William L. Lincoln, American Life Insurance Association
James T. McNamara, Prudential Insurance Company
Clifton N. Ottosen, Commissioner of Insurance Utah
S. Travis Pritchett, University of South Carolina
William R. Shands, Jr., The Life Insurance Company of Virginia
Ben P. Shields, The National Life & Accident Insurance Co.
George L. White, Metropolitan Life Insurance Company

After reviewing the charge made in the June 1974 report, the committee outlined tasks for the various members relating to the study of life agents compensation systems limiting the study to the existing system and with the projection of the study having as its objective, the question of what impact the compensation methods have on the sale of various classes of life products.

Three assignments were undertaken at this meeting:

1. The preparation of a chart representing a compilation of agents compensation by Robert R. Googins, Connecticut Mutual Life Insurance Company and an industry subcommittee.

2. An explanation and summary of New York Section 213 and 213A by Dr. Pritchett, Associate Professior of Finance and Insurance, University of South Carolina and an industry subcommittee.

3. A survey of state limitations on compensation by William Lincoln, ALIA; George L. White, Metropolitan Life; and an industry subcommittee.

Having agreed that the committee had ascertained its objectives and its assignments thereto having been made, the meeting adjourned.

The Industry Committee and the NAIC's Task Force met again on November 7, 1974, at the Mariott Hotel in St. Louis, Missouri.

Mrs. Elizabeth Tovian of LIMRA reported on studies made by LIMRA's staff on the subject of agents' compensation systems.

Mr. Robert R. Googins submitted a chart identifying the elements of an agent's compensation for consideration. It was agreed that the chart would be a useful tool in our studies and should be completed (with certain additions).

It was agreed that assignment No. 2 as set forth in the charge of June 1974 should be studied and Dr. Pritchett agreed to act as chairman of this subcommittee and make a report at the next meeting.

Ronald Doane, Equitable, agreed to head a subcommittee on assignment No. 3.

There was a final meeting of the industry committee and the NAIC's Task Force at the Camino Real Hotel on December 3, 1974.

The principal progress since the last meeting was completion of the chart which is intended to identify the elements of a life agent's compensation (within the scope of this industry committee).

The committee is most appreciative for the extreme amount of work involved in the preparation of this chart by Mr. Googins and those who assisted him. The committee is also extremely grateful for the efforts of Mrs. Elizabeth Tovian, Dr. Pritchett and Messrs. Lincoln and White. The industry representatives of this committee are extremely grateful for the guidance and suggestions made by the NAIC representatives and particularly Commissioner Farmer, Chairman of the NAIC's task force.

The industry committee feels that the study, in order to be useful as a tool to the NAIC, will involve a considerable amount of work in the future. The committee plans to have meetings of the whole group and its various subcommittees in the near future. Further reports will be made from time to time.

	TYPE OF AGENT																			
	Ordinary Career Agents		Multiline-Exclusive		Multiline-Independent		PPGA		"Life"Brokers First-line		"Life"Brokers Standard		Part-time Agents		Combination Agents-"Times"		Combination-Comm.&Cons.		Combination-Comm.&Growth	
DIRECT COMPENSATION	NY	nonNY	NY	nonNY	NY	nonNY	NY	nonNY	NY	nonNY	NY	nonNY	NY	nonNY	NY	nonNY	NY	nonNY	NY	nonNY
Commissions First-Year																				
Renewals & fees including requirements to earn and to vest																				
Other Renewal Incentives																				
Bonuses Contractual																				
Non-Contractual																				
Financing																				
Supervisory Compensation																				
Fees from Clients																				
SECURITY BENEFITS																				
Retirement-Pension Plans																				
Deferred Compensation, Profit-Sharing, etc.																				
Disability Income (LT)																				
Life Insurance																				
Medical Insurance																				
SALES SUPPORT																				
Sales Aids Proposals, Illus.																				
Descriptive Material																				
Gifts for Prospects																				
Direct Mail																				
Advertising																				
Housing, Clerical Support Supplies																				
Conventions & Meeting Expenses																				
Awards, Contests																				

Chart Definitions

1. "Life" agents generally sell individual life, pension trust, health (including disability income), fixed and variable annuities and other equity products such as mutual funds and (eventually) variable life. They may also sell property-casualty business and some group life and health.

   This material is related to individual life only.

3. Other "one-on-one" salesmen of individual life are –

   Supervisory staff:

   "Over-the-counter" salesmen (banks and stores):

   Surplus writers;

   Single case agreement writers:

3. The fees mentioned in "Renewals and fees" block are defined as follows (from A. C. Stallmaker's Life Insurance Agency Financial Management, pp. 129-130):

   Service fees in an agent's contract refer to commissions which are presumably contingent upon the agent's continuing to render service to the company and to the policyowner. In practice they often are contingent only on the agent's continuing under contract with the company and on the payment of premiums on the policy. These service fees may amount, for example, to 2 percent per year after the tenth policy year, and may continue for as long as the policy stays in force and the agent continues to service it for the company.

   Sometimes a portion of the renewal commissions in the first ten policy years is designated as a service commission. For example, a 5 percent renewal commission might be separated into a 3 percent renewal, perhaps vested, and a 2 percent service commission which would not be vested.

CHART DATA

	Ordinary Career Agents	
	New York	Non-New York
DIRECT COMPENSATION		
Commissions - FY*	50% or 55%, with majority paying 55%	50% to 80%, with majority paying 60 or 65% FY rate may actually be higher due to production bonuses.
Renewals and fees** including requirements to earn and to vest	Heaping fairly general A few companies still pay level 5% renewals. Some companies have nominal requirements for earning renewals. Vesting usually contingent on service, with some cos. requiring 15 or more years for full vesting. Usual fee 11+ is 2%. There are often requirements to earn fees.	Heaping fairly general. Negligible no. of cos. still paying level 5% renewals. Any reqs. to earn fees are quite nominal. Some cos. have service and/or production requirements for vesting. A collection fee is usually deducted from terminator's earned renewals.
Other renewal incentives	In some cases, additional nonvested renewals payable if requirements met (e.g. a certain volume when policy sold and in each subsequent year; a certain level of premiums and persistency in year policy sold; a certain level of current production).	
Bonuses Contractual	Trend toward persistency bonuses, but majority still do not have them. Usually a % of certain renewal prems. or comms. on persisting business, with more for better production, but great variation.	Great diversity, but more are % of first-year comms. or prems. or rate/M of new volume. often graded by production and/or persistency. Some are a % of certain renewals, possibly graded by production and/or persistency.
Bonuses Non-Contractual	little information available	
Financing	For inexperienced agts: 1) salary plans 2) training allowance plans 3) line of credit plans For experienced agts: usually advances against annualized commissions.	See NY column. Of course non-NY cos. are not subject to section 213

Supervisory Compensation	Agents may receive a small salary or override, or both to supervise (train, recruit, etc.)
Fees from Clients	There have been several articles (esp. MDRT) regarding charging counselling fees for financial planning and pension services (as opposed to the usual policyholder service activities, such as change of beneficiary, claims, etc.).
SECURITY BENEFITS	
Pension, Life, Hosp/Surg, Major or Comprehensive Medical, Long-term Disability	Most career agents are eligible to participate in company fringe benefit programs. Most plans are contributory. The coverages vary tremendously.
Deferred Compensation	In recent years, there has been a trend, especially in NY toward adding a deferred compensation plan to agents retirement program. Some non NY companies make entire investment.

*Shown for WL policy. % graded by type of plan.
**See definition.

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	Multiline Agents	
	Exclusive	Independent
DIRECT COMPENSATION Commissions* First-year	35% to 65% FY rates tend to be lower, overall, than the ordinary career agents'.	Usually hold a brokerage contract.
Renewals and fees** including requirements to earn and to vest	Heaped renewals plus continuous service fees are fairly common. Some companies have production requirements to earn renewals and/or fees. Most contracts provide for termination payments (in lieu of vesting) if service requirement met unless agent enters service of another insurance company within certain territory and/or time period.	
Other renewal incentives	Payment of higher renewals for better production is rare.	

Bonuses Contractual	Some companies pay life bonuses based on production/ persistency.
Bonuses Non-Contractual	No information
Financing	For inexperienced agents: training allowance and/or advance plans.
Supervisory Compensation	
Fees from Clients	
SECURITY BENEFITS	
Pension, Life, Hosp/Surg, Major or Comprehensive Medical, Long-term Disability, and Retirement	A number of companies do not provide retirement benefits, but agents are eligible for group life and hospital/ medical plans. Some companies also offer long-term disability income benefits.
Deferred Compensation, Profit-Sharing	Only a few companies have deferred compensation or profit-sharing plans for agents.

* Shown for WL policy. % graded by type of plan.
**See definition.

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TYPE OF AGENT

DIRECT COMPENSATION	PPGA (26 cos. in informal study)	"Life" Brokers First-line		"Life" Brokers Standard		Part-time Agents	
	non NY	NY	non NY	NY	non NY	NY	non NY
Commissions* First-Year	Including overrides, from 70% to about 100%	55%	55% to 90%	55%	55% to 90%	50%-55%	50%-75%

Renewals & fees** including requirements to earn and to vest	Usually heaped, with continuous 2% fees 11+. Some cos. have production or persistency requirement to earn renewals. Some have service or inforce requirements for vesting	Usually 9 5%'s but may be heaped, with requirements to maintain contract or get fees (commonly 1200 1st-yr. comms). Fully vested.		Most usual – 9 5%'s, fully vested; for other possibilities, see "First line" columns. There may be only one brokerage contract, with factors paid to anyone who qualifies.	Realtively few companies have a contract designated "part-time" When they do, the contract usually pays 9 5%'s fully vested.
		Continuous 2% fees but may be replaced with bonus or benefit.	Some pay continuous 2% fees.		
Bonuses Contractual	Production/persistency bonuses; some manpower allowances and bonuses based on subagent production	Possibly persistency bonus. Infrequent.	Bonuses in about 1/4 of cos.: production, persistency, etc. May be in lieu of fees.		Uncommon
Non-Contractual	NO INFORMATION				
Financing	Most often annualization or advance against annualized comms.				
Fees from Clients					
SECURITY BENEFITS Retirement-Pension Plans	Sometimes lifetime fees. We understand that as independent contractors they are not eligible for "qualified" pension plans.	Some companies pay lifetime fees to qualifying brokers.			

Disability Income, Life Insurance, & Medical Insurance	Usually available to PPGA's.	Group life and health are generally available to first-line brokers, but sometimes there is only one contract: benefits are available to whoever qualifies for them.	May be eligible for group life and hospital/medical benefits.
Deferred Compensation, Profit-Sharing, etc.			

*Shown for WL policy. % graded by type of plan
**See definition.

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	Combination Agents		
DIRECT COMPENSATION	"Times" Contract	"Comms. & Conservation" Contract	"Comms. & Growth"
Commissions First-year	"Times" = a multiple of the increase in the amt. of premium collected (net of controllable lapses). A no. of "times" are paid for selling and conserving debit business.	% of 1st-yr. premium (less 1st-yr. lapses), graded by type of policy.	See "Comms. & Conservation Contract."
Renewals	Collection commissions: flat amount/week or % of premiums, related to size and type of debit, collection percentage, etc.		
Other Renewal Incentives		Conservation comms.: based on size of debit and renewal lapse rate.	Growth factor based on gain in in-force: a multiple, a percent or a rate per dollar of the net increase is credited to agent's account. Agent receives % of account balance.
Bonuses Regular	Additional no. of times on premium increase.	Additional % of sales commission or of total earnings.	

Other	Seniority/longevity bonuses; vacation/holiday allowances; Collection commission bonus based on collection percentage; bonuses on ordinary business.
Financing	1. Starting pay for specified number of weeks; may be advance against future earnings. 2. Training allowances (less common).
Supervisory Compensation	
Fees from Clients	

SECURITY BENEFITS

Pension, Life, Hosp/Surg, Major or Comprehensive Medical, Long-term Disability Income	Combination agents are usually eligible for full line of coverages under home office employee plan.
Deferred comp; profit-sharing, stock options, etc.	The pension plan is sometimes a profit-sharing plan; some companies also offer stock purchase plans.

N.B.: 1) Some companies have "hybrid" contracts, combining elements of the three primary types.
2) "Times" contracts are more common among small companies.
3) Under "times" contracts, Regular Ordinary is usually handled separately; under C & C and C & G contracts, RO may be annualized and credited to account.

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SALES SUPPORT

Sales Aids

Proposals and Illustrations	Agencies usually have proposal clerks. Electronic programming and policy illustration services provided by many home offices. Also advanced sales assistance provided by home office and agency specialists. For pension business, such services as annual valuations, employee booklets, and updating provided. Agent may be charged for services.
Descriptive Material	Pretty generally available. Many visual proposals. Sales kits for new products (possibly decreasing).
Gifts for Prospects	Have examples of company catalogs listing such items as baby books, pens, fans.
Direct Mail	1. Preapproach letters and 2. gift offers; most commonly agent charged for postage only.

Advertising	Cooperative advertising programs. Have examples of company manuals, but no measure of extent to which advertising is available to agents (as opposed to agencies).
Housing, Clerical Support, Supplies (Generally applicable to ordinary career agents. See attached for breakdowns of certain items among career, multiline and combination)	Full-time agents usually housed in agency office. Allowances for detached agents more common among managerial companies. Clerical assistance provided. Personal secretarial assistance for qualifying agents more common among career general agency companies. Estabished agents may have to pay for personalized supplies and sales aids.
Conventions and Meeting Expenses	3-day companywide conventions more common. Many non-NY companies will pay for spouse's attendance if "double qualification" met (not permitted for NY companies).
Awards, Contests	Considerable variation in types of contests and prizes for winners (usually no limit on number of winners). Among non-NY companies, merchandise is most popular award. NY companies limited to awards of "small intrinsic value".
Training	Training material provided. Many companies conduct home office schools and seminars, and support LUTC and CLU.

LIMRA 11/74

	Ordinary Career G.A.	Ord. Career Managerial U.S.	Ord. Career Managerial Canadian	Ord. Career Managerial Total	Combi-nation	Multiple-Line	Total (Ex-cluding PPGA)
11. When an agent occupies office space that is not paid for by the home office or agency manager, is that agent paid an allowance?							
Yes	9	23	11	34	--	2	45
No	26	13	12	25	30	25	106
No response	10	5	--	5	4	7	26
	45	41	23	64	34	34	177
12. What is the approximate average ratio in your field offices of field clerical staff to full-time agents? (This table excludes the very few companies not operating on a home office billing basis.)							
Range	1:2-1:15	1:3-1:10	1:2-1:10	1:2-1:6	1:3-1:15	1:5-1:14	--
Median	1:5	1:5	1:5	1:5	1:7	1:5	--
Mode	1:5	1:5	1:5	--	1:7	1:5	--
Number of companies	25	23	37	60	24	11	120
13. Is personal secretarial help provided for certain agents?							
Yes, by home office	5	14	10	24	4	7	40
Yes, by manager or general agent	23	9	3	12	0	6	41
No	16	17	10	27	30	19	92
No response	1	1	0	1	0	2	4
	45	41	23	64	34	34	177
14. Do you assume the cost of any insurance publications or services?							
For field offices							
Yes	26	32	18	50	21	20	117
No	16	3	4	7	13	11	47
No response	3	6	1	7	--	3	13
	45	41	23	64	34	34	177
For individual agents							
Yes	12	8	4	12	6	10	40
No	27	22	11	33	23	18	101
No response	6	11	8	19	5	6	36
	45	41	23	64	34	34	177
15. Do you pay all or part of any dues for organizations to which your agents may belong?							
Yes	11	9	5	14	11	9	45
No	34	32	18	50	23	25	132
No response	0	0	0	0	0	0	0
	45	41	23	64	34	34	177
16. Do you provide a travel allowance for your agents in connection with their normal work (excluding convention travel)?							
Yes	1	2	1	3	14	6	24
No	44	39	22	61	20	28	153
No response	0	0	0	0	0	0	0
	45	41	23	64	34	34	177

Source: Field Office Budgets & Services, LIMRA, 1973-7

Valuation and Nonforfeiture Value (C3) Task Force

Mexico City, Mexico
December 2, 1974

The contents of this report are:

I. TASK FORCE PROCEEDINGS

A. Definition of the task.

1. Review valuation and nonforfeiture value legislation and regulation.

2. Identify problems currently encountered and recommend practical solutions which can be implemented now.

3. Consider the fundamental purposes of statutory regulation, study systems alternative to the present using theories and techniques not previously available, and eventually recommend some course of long range development of statutory regulation.

B. Problems where action is needed.

Three sets of problems have been identified:

1. Those requiring some form of current action of a "stop gap" nature until a long range solution can be developed.

2. Those which must be answered before investigations into longer range solutions to valuation and nonforfeiture value regulation problems can be undertaken.

3. Those related to the present policy reserve valuation system which require a longer range view.

1. Immediate Problems.

   a. Are there alternatives to premium deficiency reserves?

      (1) What are the consequences of each alternative both with respect to level premium, level amount plans, and with respect to plans with premiums and/or amounts varying by policy duration?

      (2) Is a revision of current minimum reserve mortality and interest assumptions needed?

   b. How is the "uniform percentage of gross premium" rule being taken advantage of, both for valuation net premiums and nonforfeiture values?

      (1) What modifications are needed?

      (2) To what extent should products specifically designed to take advantage of this rule be permitted?

      (3) Should special rules be developed for Deposit Term, Split Life and other special products?

   c. Does the expense assumption in the nonforfeiture value formula need revision?

   d. What modifications are needed for index-related general account plans?

   If the role of the Task Force is expanded to include all of the lines of insurance within the jurisdiction of the (C) Committee, then the problems of health insurance valuation, credit insurance valuation, and variable life insurance and annuity valuation and nonforfeiture values would also be included.

2. Questions to be answered before longer range solutions can be undertaken.

   a. What forms of valuation and nonforfeiture value regulation exist elsewhere in the world at present, and to what extent do they consider the application of risk theory and the credibility of experience assumptions?

   b. What alternate forms of regulation should initially be proposed by the Task Force and investigated?

   c. Should the smaller and/or younger companies be considered differently than the larger, older, more established companies?

3. Problems with the present statutory policy reserve system.

   a. Even though statutory reserves are being held, solvency may not be assured by the present system if asset values are inadequate to match and support the policy liabilities with respect to the future timing of benefits, withdrawal values and dividends. It appears that the present system may not provide sufficient consideration of the possibility of this inadequacy.

   b. The present system is not readily adaptable to products of an index-related nature.

c. The present system may not be responsive enough to changes in mortality, morbidity, expenses, interest rates or other factors involved in the operations of a life insurance company.

d. The present system does not directly produce earnings for life insurance companies that are comparable to the earnings reported for companies in other industries.

e. The present system ignores the variation of the credibility of experience with respect to the number and relative magnitude of the separate risks assumed with respect to investments, mortality and morbidity.

f. The present system ignores the effect of reinsurance in spreading risk.

g. The present system may not be responsive enough to the nature of all benefits to be provided for, including nonforfeiture benefits.

C. How the Task is to be Accomplished.

1. Recent activity of the Society of Actuaries.

At the meeting, October 27, 1974, of the Society of Actuaries Special Committee on Valuation and Nonforfeiture Laws the recommendation was made to the Board of Governors of the Society that the Society Committee wind up its activities as soon as possible (six to eight months) and become an advisory committee to the NAIC Task Force, reporting through the Board of Governors of the Society. The Board of Governors voted to accept the recommendation. Notes on the proceedings of the Society Committee, including the specific wording of the recommendation to the Board of Governors, are given as Attachment A to Exhibit 4, minutes of October 28, 1974, attached to this report.

At the meeting of the Society of Actuaries, October 28, 1974, in New Orleans was announced that the membership of the Society had voted to make Article X to the Constitution of the Society, which concerns the public expression of professional opinion, a permanent Article of the Constitution. The text of this article is:

> No opinion shall be publicly expressed by, or on behalf of, the Society of Actuaries, the Board of Governors, or any committee except on matters within the special professional competence of actuaries and then only in accordance with authority given and
>
> 1. An opinion of the Society shall require advance approval by an affirmative vote of at least two-thirds of the Fellows who vote in a mail ballot. Such ballot shall not be deemed to authorize expression of opinion unless votes are received from a majority of all Fellows. The public expression, if any, shall indicate the result of this vote and shall state any substantial contrary opinion expressed by responders to the ballot.
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> 2. An opinion of the Board of Governors or a committee authorized by the Board to express an opinion shall be publicly expressed only if it has been approved by an affirmative vote of at least two-thirds of all the members of the Board or if the committee as the case may be. It shall indicate that it does not purport to represent the views of the Society of Actuaries, but only of the Board or committee that expresses it. It shall state any substantial contrary opinion expressed by members of the Board or committee.

Discussion by the Task Force of the effect of the adoption of the Special Society Committee recommendation by the Board of Governors and the effect of the adoption by the Society membership of the permanent form of the Article on public expression has resulted in the attempt presented later in this report to define the responsibilities of the Task Force and the various advisory members.

2. Definitions of Responsibilities.

a. Task Force Members.

The actual members are the commissioners of the various states who are members, but include as many technical working members from the staffs of such various member state insurance departments as deemed necessary and as are available for the conduct of the work of the Task Force. (There are a number of states, not technically members of the Task Force who have been providing staff to attend meetings of the Task Force. This gives cause to the need for expanding the Task Force, perhaps into a Technical Subcommittee manned by various insurance department technical staff employees such as is now done with the various Blanks Technical Subcommittees reporting to the (A1) Blanks Subcommittee.)

These members have the ultimate responsibility for:

(1) Definition of the work to be undertaken.

(2) Determination of the advisory committees and subcommittees needed, their structure, and their charges.

(3) Review and direction of the work of the advisory subcommittees, including independent investigations by individual members of the Task Force if they wish to verify results of a subcommittee's findings, or if such results appear questionable in any way.

(4) Presentation to the NAIC of the results of the work undertaken in the form of recommendations, including, if the Task Force deems necessary, recommendation for model regulation or legislation, or revision of present model regulations or legislation.

b. Advisory Committee.

The function of the Advisory Committee to the Task Force is to serve as a body of independent professional actuaries representing, but not speaking for, various organizations and whose functions include aiding the Task Force in working with the Technical Advisory Subcommittees, both in describing the charge to those subcommittees, and in evaluating their work, and acting as a communication or information exchange medium. A number of members have specific resources, experiences, or channels of information unique unto themselves which make them extremely useful to the needs of the Task Force.

The Advisory Committee has been appointed and is comprised of: Robert Houser, Chairman, representing the Society of Actuaries; Gary Corbett, representing the American Academy of Actuaries; James Hickman, representing the academic community; Michael Jordan, representing the National Association of Life Insurance Companies; Richard Minck, representing the American Life Insurance Association.

c. Technical Advisory Subcommittees.

(1) The members of these committees are to be drawn from whatever resources the NAIC Task Force deems necessary to the performance of the duties assigned to the specific committee necessarily be limited to members of the Society of Actuaries or even the American Academy of Actuaries. Depending upon the responsibility of the committee it is conceivable that economists, lawyers, mathematical theorists outside the actuarial profession and a number of other professionals might be needed.

In selecting members it is important that such members not be placed in the position of dual responsibility with respect to policy making advice. The distinction of advice needed by the Task Force between that of technical nature and that of a policy forming nature is a vital factor in the selection of members for various roles. Each prospective member must make the Task Force aware of all commitments he may have and, if appointed, must continue to make the Task Force aware of any changes in commitment.

(2) Three types of members are to be considered for technical advisory subcommittees:

(a) Working Members.

These are expected to furnish staff and facilities for designing and testing various approaches to solving a particular problem assigned to a specific committee. (Alternate procedures would be either to ask the American Academy of Actuaries for views on the problem, or to obtain grants of money to finance a specific study by some academic or research organization.)

(b) Resource Members.

These members have some special talent or knowledge and are expected to provide:

(i) The use of such talent or experience.

(ii) Review and comment with respect to various phases of research.

(c) Liaison Members.

Because of the possibility that what is accomplished by a particular study may have application in another sphere of actuarial activity, representatives active in those various spheres should be brought in as liaison members to provide a channel of communication. Should it later become feasible to develop procedures analogous to those developed under this Task Force, these members could then form a nucleus for an advisory committee in that area.

(3) The general form of communication between the Technical Advisory Subcommittee and the Task Force should consist of:

(a) The initial definition by the Task Force for the Technical Advisory Subcommittee of some rather broad or general directives. (Unless some specific immediate problem is deemed important enough to require the sole attention of a particular committee, in which case a more detailed directive would be given by the Task Force.)

(b) The reply by the subcommittee to the Task Force should give several alternatives for consideration.

(c) The Task Force will review the reply and decide on which alternatives should be pursued or, if none appear satisfactory, either send the reply back to the Technical Advisory Subcommittee for more work or decide directly on the alternatives to be pursued.

(d) The form of exchange as indicated above will be continued for successive levels of refinement until the Task Force is satisfied that it has a result that can be translated by the task force into some form of recommended action by the NAIC.

3. Organization Currently Proposed.

In addition to the Task Force and its general advisory committee as now constituted, the Technical Advisory Subcommittees presently contemplated are:

a. Technical Advisory Subcommittee To Consider Immediate Valuation and Nonforfeiture Value Regulation Problems.

The Task Force should define these problems specifically, offer one or more solutions to each problem, and ask the committee to research or test the implications of adopting each solution suggested. If the advisory subcommittee comes up with some solution not suggested by the Task Force, it should define that solution and ask the Task Force for permission to test that solution as well.

b. Technical Advisory Subcommittee On The Long Range Aspects Of Valuation Regulation.

(1) This committee is charged with investigating, defining, testing and finally deriving in the regulatable form various alternative valuation procedures for the purpose of measuring the adequacy of a company's financial structure to survive adverse conditions within a specified degree of certainty with the intent of preserving the solvency of the company. The communications cycle described above will be repeated many times. At a later stage this committee may also be charged with defining and testing tolerance levels for the various parameters to be used in developing regulations.

(2) The approaches should include, but certainly not be limited to, consideration of:

(a) The application of risk theory through the introduction of the chance of fluctuation in the various parameters (interest, mortality or morbidity or claim losses, lapse and expense).

(b) The application of credibility through considering both the magnitude and number of risks involved and the effect of reinsurance.

(c) The nature of the assets required to support the development of reserves and the payment of various cash items (claims, cash surrender values, policy loans, and annuities).

(d) A gross premium valuation approach to the valuation system.

(3) More specifically the responsibilities of this Subcommittee can be outlined as:

(a) The definition of the areas to be covered:

(1) Initially all life insurance and annuity forms except those associated with separate accounts.

(2) Later, if the NAIC grants extention of the area of authority to the Task Force, the application and adaptation of the basic theoretical concepts developed of other lines of insurance and annuities including the formation of special advisory Task Forces to this subcommittee for:

(i) Separate Account Business.

(ii) Health Insurance.

(iii) The various Fire, Casualty and Property Liability lines of insurance.

(b) The Technical Advisory Subcommittee should determine what problems are arising with the present valuation system and what impact the assets portfolio has on the adequacy of the reserve system to measure and maintain solvency. (The Task Force will of course form its own independent conclusions and recommendations taking into consideration the findings of the advisory subcommittee on this subject).

(c) The Technical Advisory Subcommittee should formulate some alternative solutions for the consideration of the Task Force whose members must then decide the priority of investigation of the alternative.

(d) For each alternative:

(1) Develop the theoretical background in a form for regulation.

(2) Test each theory or alternative method to be considered.

(4) The structure of the Technical Advisory Subcommittee should include a Chairman and Vice-Chairman, either of whom can be a working member or a resource member, from 7 to 10 working members, as many liaison as are needed to provide contact with the various fields of actuarial endeavor, and resource members as needed and available.

c. Technical Advisory Subcommittee On The Long Range Aspect Of Nonforfeiture Valuation Regulation.

(1) This Subcommittee will be responsible, under the guidance of the Task Force, for the investigation and definition of a nonforfeiture value system alternative to that presently required by statute. Such investigation should include the feasibility of returning to the British system. Attempts should be made to keep any alternative proposed as simple as possible. The whole concept of equity should be reexamined in the light of present day developments with respect to products, economic conditions and the competition for the consumer dollar.

(2) Since the Society of Actuaries Committee is at least six to eight months away from a final report in this area, the subcommittee should be organized as soon as possible so as to obtain whatever information as has been developed to date by that committee and should proceed with a preliminary review. The NAIC Advisory Subcommittee need not be limited to the background material developed by the Society of Actuaries Committee and may proceed with further investigations if the Task Force feels they are needed.

(3) The structure of this Subcommitteee like the corresponding Subcommittee for the long range aspects of valuation should include a Chairman, Vice-Chairman, Working Members, Resource Members and Liaisòn Membérs.

D. Status of Projects.

1. Summary of Developments Over the Past Thirty Years.

A summary of developments has been prepared by Dan Case and Grace Dillingham of the American Life Insurance Association and is attached to this report as <u>Exhibit One</u>. The Task Force is very appreciative of the extensive time these two individuals spent in reading the voluminous transactions recording these events and in writing the digest of those events.

2. Analysis of the Questionnaire Answers.

Work is proceeding on this analysis. There is nothing further to record on this subject at this time.

3. Current Problems.

Certain members of the Task Force will be assigned various problems. They will obtain advice needed and prepare a report for review by the entire Task Force.

4. Long Range Valuation Problems.

A Technical Advisory Subcommittee is being organized to obtain information for the Task Force.

5. Long Range Non-Forfeiture Problems.

A separate Subcommittee of Task Force members is to be organized to define these.

E. Transactions.

1. Meetings.

a. Milwaukee, August 14, 1974

See Exhibit Two for the minutes of this meeting. Discussion at this meeting concentrated on the role of the Task Force and its various advisors and their interrelationships.

b. New Orleans, October 26 and 28, 1974.

See Exhibit Three and Exhibit Four, respectively for minutes of these meetings. The function of the Society of Actuaries Committees in relation to the NAIC Task Force was the principal item of discussion at these meetings.

c. Mexico City, December 2, 1974.

2. Correspondence.

Items of correspondence attached as Exhibit Five to this report are:

a. June 20, 1974, LaMar Walker, Utah.

(1) A & H Policy with return of premium benefit.

(2) Whole life policy at 1958 CSO with 0% interest assumption.

b. August 22, 1974, LaMar Walker, Utah.

Reserve for guaranteed interest in excess of that required by statutory authority.

c. October 30, 1974, W. Keith Sloan, Arkansas.

Need for and nature of advisory groups.

d. November 13, 1974, C.F.B. Richardson, Tennessee.

Deposit Term Questionnaire.

e. November 13, 1974, W. Keith Sloan, Arkansas.

Transition to 4% reserves.

f. November 18, 1974, Ted Beker, Texas.

Course of Task Force Action.

g. November 20, 1974, William A. White, New Jersey.

Views on the functions of the Task Force and its advisory groups.

II. RECOMMENDATIONS

A. The (C3) Task Force on Valuation and Nonforfeiture Value Regulation should be reorganized as a Technical Subcommittee to the (C3) Life Subcommittee analogous to the roles of the various Blanks and Technical Subcommittees to the (A1) Blanks Subcommittee.

This will permit the participation of technical staffs from a wider range of state insurance departments than currently allowable as a Task Force. This will make a fact of participation by the technical staffs of various non member states in the activities of the Task Force.

B. The Task Force (or Technical Subcommittee) should be given authority to directly ask the American Academy of Actuaries to provide, within a specified time limit, advice on specific technical questions the Task Force feels need to be answered by a representative body of qualified actuaries. The Task Force will consider the advice so obtained but should not necessarily be obligated to follow it.

Examples of such advice could be the construction of a new mortality table or the investigation of valuation regulation current in other countries.

NOTE: Tacitly assumed in the assignment to the Task Force is that it will ask independent advice from persons free of conflicting commitments and that advisory subcommittees as needed will be organized to consider specific assignments. Such advisory groups will include persons with other than actuarial experience if the Task Force feels that they are qualified.

Mr. John O. Montgomery, California, Chairman; Mr. William A. White, New Jersey; Hon. Benjamin R. Schenck, Superintendent, New York; Mr. Ted Becker, Texas; Hon. Stanley C. DuRose, Commissioner, Wisconsin.

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EXHIBIT ONE

History of the Standard Valuation
and Nonforfeiture Laws Since
NAIC Adoption in 1942
by
Dan Case and Grace Dillingham, ALIA

The Standard Valuation and Nonforfeiture Laws were unanimously adopted by the National Association of Insurance Commissioners on November 30, 1942. The form adopted was that developed by a Committee of Commissioners, after reviewing the proposals of the Committee To Study Non-Forfeiture Benefits and Related Matters (the second Guertin Committee, successor to the Committee To Study the Need for a New Mortality Table and Related Topics, also chaired by A. N. Guertin, Actuary of the New Jersey Department) and the counter – proposals of the Association of Life Insurance Presidents and the American Life Convention. Most of the provisions of the original model legislation are still in effect, although a few have been greatly changed and a number of new provisions have been added in the course of the years. The purpose of this memorandum is to trace the history of those changes and additions.

Although the model legislation had been enacted in fourteen states within a year of its approval by the NAIC, and the proposed reserves and nonforfeiture values were reported to be acceptable under existing statutes in twelve additional states, it was not until 1949 that the legislative process was complete. Meanwhile, a "Working Committee on Standard Non-Forfeiture and Valuation Laws" had been appointed early in 1946 to advise the NAIC and the various insurance departments on the interpretation of the laws, and to consider the technical problems arising from time to time in connection with the laws. This committee was under the chairmanship of Russell O. Hooker, Actuary of the Connecticut Department, who had been vice-chairman of the Guertin Committee, and, like the Guertin Committee, it was composed largely of insurance department actuaries. Its first action was to recommend three changes in the Nonforfeiture Law; these were adopted by the NAIC on December 10, 1946.

The first amendment modified the requirement that the method of calculating the cash surrender value and paid-up nonforfeiture benefit be stated in the policy. A resolution adopted at the same time established the term "Standard Non-Forfeiture Value Method" as an adequate statement of method described in the Standard Nonforfeiture Law.

The second amendment provided for the exclusion of extra premiums on substandard business from computation of nonforfeiture values. The third conformed the standard law to what was being enacted in the several states with respect to effective and operative dates.

The following year, the Committee recommended (April 10, 1947), and the NAIC approved (June 5, 1947), extension of the disability and double indemnity mortality tables to additional ages. A further extension of the double indemnity mortality table was recommended (April 6) and approved (June 30) in 1949.

A number of opinions concerning interpretations of the laws, expressed by the Hooker Committee during the course of numerous meetings, were ratified by the NAIC at subsequent plenary sessions. By the end of 1950, the following points had been established:

1. The insured should be given the benefit of paid-up nonforfeiture benefits at any duration, fractional or integral, where they are produced by the formula. Cash surrender values need not be provided until premiums have been paid for at least three full years. (October 21-22, 1946, ratified December 10, 1946.)

2. Reservation of the right to defer payment of cash surrender values for six months is mandatory. States should consider including policy loans in the mandatory deferment provision. (October 21-22, 1946, ratified December 10, 1946.)

3. The minimum cash values and paid-up nonforfeiture benefits computed according to the extended CSO Table are applicable to policies carrying temporary extra premiums. (October 21-22, 1946, ratified December 10, 1946. As noted above, an amendment to the law was proposed with respect to permanent extra premiums.)

4. The Standard Nonforfeiture Law is applicable to single premium policies. Since premiums have been paid for the duration of the policy, the minimum cash surrender value at any point is the net present value of the future guaranteed benefits provided by the policy. (December 7, 1946, ratified December 10, 1946.)

5. The cash surrender value of any paid-up or reduced paid-up policy is an amount not less than the present value of the future guaranteed benefits. (October 7, 1947, ratified December 10, 1947.)

6. The value of any paid-up nonforfeiture benefit shall be "at least equal to" the corresponding cash surrender values, including cash values which have been adjusted upward to the next higher dollar. (December 7, 1946, ratified December 10, 1946.)

7. A policy providing term insurance for several years, automatically followed by permanent insurance, may be treated as two separate policies if the portion providing permanent insurance takes the Company's regular rate at the then attained age. A policy which provides for an initial premium and an increased premium at a subsequent duration which differs from that for a new policy at the attained age constitutes a single policy to which the nonforfeiture formula should be applied at the outset. (October 21-22, 1946, ratified December 10, 1946.)

8. Level term riders and basic policies should be combined for the purpose of determining minimum nonforfeiture values, but may be combined or separated for determining actual values. (October 21-22, 1946, ratified December 10, 1946.)

9. Decreasing term riders need not be considered in calculating nonforfeiture benefits if the Act would not apply to similar provisions issued as a separate policy. No valid reason was seen for the apparent discrimination against level term riders, but an amendment to the Act would be required to remove it. (October 7, 1947, ratified December 11, 1947.)

10. In the case of an endowment policy providing a varying death benefit, the "equivalent level amount" of insurance is the level amount of insurance equivalent to the varying amount of insurance in the original policy, while the endowment benefit in the "equivalent" policy is equal to the endowment benefit in the original policy. (April 10, 1947, ratified June 5, 1947.)

11. In the case of juvenile policies providing for a premium return benefit in the event of death prior to a fixed date and automatic insurance for the face amount thereafter, the amount of the premium return benefit must be considered as "insurance," even though this results in an extremely low "eqivalent level amount" and thus in "unreasonably high" cash values. The Committee noted that the laws of two states and the original proposals of both the Guertin Committee and the industry group provided specifically for this type of policy, and suggested that an appropriate amendment to the model law might be considered. (June 2, 1974, ratified December 11, 1974.)

12. Coupons under coupon policies should be treated as a series of pure endowments in the calculation of minimum cash values. (June 13, 1950, ratified December 14, 1950.)

13. The Standard Valuation Law provides that policies providing varying amounts of insurance shall be valued by "a method consistent with the principles" of the Commissioners Reserve Valuation Method. Consistent methods include, but are not necessarily limited to, those developed by Menge in RAIA, XXV, p. 258, and Espie in TASA, XLVII, p. 43. (December 8, 1947, ratified December 11, 1947.)

14. There is no objection to the continued use of the expression "New Jersey Standard Method of Valuation" and "Illinois Standard Method of Valuation" to describe the valuation methods known by those names, notwithstanding the repeal of the state laws defining the methods; nor the use of the methods, since in aggregate they produce slightly higher reserves than the Commissioners Reserve Valuation Method. (October 7, 1947, ratified December 11, 1947.)

A number of amendments to the standard laws, in addition to the three adopted in 1946, wery proposed during this period. Although never acted upon by the NAIC, they eventually found their way into the laws of many states. These included an exclusion of substandard extra premiums from reserves as well as from nonforfeiture values; exemption of non-U.S. business of alien companies from the valuation law; special provisions for computing nonforfeiture values in the case of a policy providing a varying amount of insurance issued on the life of a child under the age of ten; and exemption from the nonforfeiture law of level as well as decreasing term riders if the law would not apply when the benefit was issued separately. The last two had been recommended, in substance, by the Hooker Committee to solve problems which had been created, in a sense, by its own interpretations of the laws.

From June, 1950, until June, 1956, the standard nonforfeiture and valuation laws appeared to give little trouble. They had been enacted whenever necessary, a few correcting amendments had been made, and their seemed to be agreement, if not satisfaction, on the handling of juvenile policies, retirement income policies, term riders, and coupon policies. Then rising interest rates combined with falling mortality rates to introduce a new problem.

Deficiency reserves had not been a problem when the Guertin Committees issued their reports in 1939 and 1941. The earlier committee, however, while admitting that the problem was more theoretical than real, had pointed out that if conditions (i.e., high interest rates) which had prevailed some years earlier should return, the use of an out-dated mortality table for valuation purposes would be a barrier to lower non-participating premiums. In 1956, Mr. Guertin, by that time Actuary of the American Life Convention, reported that those conditions had returned. Interest rates were climbing, and if the 1941 CSO Mortality Table was not as old in 1956 as the American Experience Table had been in 1939, it was nevertheless displaying the same characteristics of mortality rates much higher, particularly at the younger ages, than current experience. On behalf of the American Life Convention and Life Insurance Association of America, Mr. Guertin asked the NAIC to appoint a subcommittee to study the matter. The NAIC agreed, and the Subcommittee on Deficiency Reserves was duly appointed under the chairmanship of Charles R. Howell, Commissioner from New Jersey.

In July, 1956, at the request of the Subcommittee, the Society of Actuaries appointed a Special Committee on New Mortality Tables, with A. N. Guertin as Chairman, to assist the NAIC Subcommittee in its study of deficiency reserves and the need for a new mortality table. After holding several separate meetings, the two committees met jointly on October 8, 1956. As a result of these sessions, a new mortality table, Table X17, was developed on the basis of ultimate mortality experience during the 1950-1954 period, with margins.

There was extensive discussion of the proposed new mortality table within the Society of Actuaries and in the various life insurance organizations. At the June, 1957, NAIC Meeting, there occurred considerable debate as to the desirability of adoption by the NAIC of Table X17. The Life Committee decided to postpone action, to enlarge the Subcommittee, and to change its name to the "Subcommittee on Deficiency Reserves and Mortality Tables Review," and Cyril Sheehan, Commissioner from Minnesota, was named as Chairman.

The newly designated Subcommittee submitted, and the NAIC accepted at its December, 1957 meeting, the following recommendations:

1. That the principle of deficiency reserves as set forth in the Standard Valuation Law is sound and statutes embodying such principles should be retained.

2. That it is in the public interest to review periodically the mortality tables that form the bases of the statutory minimum valuation standards.

3. That the X17 Table should be referred back to the Committee appointed by the Society of Actuaries for reconsideration and recommendation of the loading factors applied to the lower age groups without the limitations suggested by the previous Subcommittee's instructions and that the committee of the Society of Actuaries should also be invited to make separate specific recommendations concerning collateral problems to be referred to it by the Subcommittee.

Pursuant to a suggestion by the Special Committee of the Society of Actuaries, the Chairman of the NAIC Subcommittee appointed an Industry Advisory Committee, naming R. H. Rydman, General Counsel of the North American Life & Casualty Company, as Chairman, in April, 1958. The Industry Advisory Committee reported to the Subcommittee in June of 1958, just prior to the NAIC Meeting. Among the recommendations it agreed upon unanimously were the following:

1. After thorough documentation the Committee agreed there is a need for a new table.

2. After suggesting a directional pattern of practical changes, it was recommended that work by a properly constituted technical committee be undertaken without delay.

The NAIC Subcommittee on Deficiency Reserves and Mortality Tables Review recommended at the June, 1958, NAIC Meeting that it be continued and that it be empowered to appoint a Committee of Actuaries from among the several State Insurance Departments. An Industry Actuarial Advisory Committee was also appointed, with James T. Phillips, Senior Vice-President and Chief Actuary of the New York Life Insurance Company, as Chairman, and given the following assignments:

1. Construct a new mortality table for the valuation of standard Ordinary insurance that would include adequate margins at all ages for universal usage throughout the country and that would, thus, take account of the important practical problem raised by the Industry Advisory Committee, namely, the belief in some quarters that the margins, at least at some ages, are not adequate for universal usage throughout the country.

2. Construct a new mortality table that could be used as a maximum basis for determining the amount of extended term insurance provided as a non-forfeiture benefit that would take account of both the higher mortality experienced on the extended term insurance benefit and the expense of maintaining this benefit in force.

The Industry Actuarial Advisory Committee submitted its unanimous Report to the NAIC Subcommittee on September 29, 1958. The Committee constructed three new mortality tables:

1. The 1958 CSO Table, which was recommended as an appropriate valuation basis for standard Ordinary insurance.

2. The 1958 CSO Basic Table, which is a graduated mortality table representative of average company ultimate mortality experience on standard Ordinary insurance between 1950 and 1954 policy anniversaries.

3. The 1958 CSO-A Table, which was recommended as an appropriate maximum basis for determining the present value of the extended term insurance non-forfeiture benefit which, in the opinion of the committee, provided for both the higher mortality experience; by some companies under the extended term insurance benefit and the expense of maintaining this benefit in force. This table was constructed by adding a loading of .75 deaths per 1,000 to 130% of the 1958 CSO mortality rates.

The Industry Actuarial Advisory Committee also went on record with some related conclusions which were subsequently acted upon by the NAIC.

After exposing these recommendations to all Insurance Commissioners and to the life insurance companies through their trade associations, and after obtaining a further review of all available statistics by the Industry Actuarial Advisory Committee, the NAIC Subcommittee arrived at the following recommendations:

1. The maximum basis for determining the value of the extended term insurance non-forfeiture benefit would be a new mortality table constructed by adding a loading of .75 deaths per 1,000 or 30% of the 1958 CSO Table mortality rates, whichever is greater, to the 1958 CSO Table mortality rates; and

2. The maximum basis for determining the value of the reduced paid-up insurance non-forfeiture benefit would be the 1958 CSO Table.

Representatives of all trade associations present at the December 13, 1958 Subcommittee meeting endorsed the conclusions of the Subcommittee. On December 15, 1958, the Subcommittee met again and agreed on model legislation which would accomplish the following objectives:

1. The Standard Non-forfeiture Law

   A. Substitute the 1958 CSO Table for the 1941 CSO Table.

   B. Substitute the Commissioners 1958 Extended Term Insurance Table for 130% of the 1941 CSO Table.

   C. Make the mandatory operative date January 1, 1966, but permit an optional operative date to be any date between the effective date of the law and January 1, 1966, as elected by a company.

   D. Make the change applicable to all Ordinary policies issued by a company after the operative date.

   E. Permit for females the use of an age not more than three years younger than the actual age for policies issued on the basis of the 1958 CSO Table and the 1941 CSO Table. (To meet individual state requirements the Model Legislation was drafted so as to make the female age setback applicable to either (a) Both the 1958 CSO Table and the 1941 CSO Table, or (b) Only the 1958 CSO Table.)

2. The Standard Valuation Law

   A. Substitute the 1958 CSO Table for the 1941 CSO Table.

   B. Make the operative date the same as the operative date of the Standard Non-forfeiture Law.

   C. Make the change applicable to all Ordinary policies issued by a company after the operative date.

   D. Permit for females the use of an age not more than three years younger than the actual age for policies issued on the basis of the 1958 CSO Table and the 1941 CSO Table. (To meet individual state requirements the Model Legislation was drafted so as to make the female age setback applicable to either (a) Both the 1958 CSO Table and the 1941 CSO Table, or (b) Only the 1958 CSO Table.)

The Report of the Subcommittee on Deficiency Reserves and Mortality Table Review was unanimously adopted by the Life Insurance Committee on December 17, 1958, and by the NAIC in plenary session on December 18, 1958. State legislatures acted rapidly, and the new tables, mandatory by January 1, 1966, were permissive in all states by January 1, 1963, or earlier.

Meanwhile, various developments in the life insurance business suggested the desirability of a review of the Standard Nonforfeiture and Valuation Laws apart from the introduction of the new mortality table. Accordingly, a subcommittee of the ALC-LIAA Joint Legislative Committee undertook a study of such matters as the treatment of level term riders and family policies, the modernization of the valuation bases for disability and accidental death benefits, and the approval of new mortality tables for annuities, both individual and group. As a result of this study, ALC-LIAA recommended to the NAIC on December 2, 1959, a number of amendments to the standard laws, which were adopted by the Commissioners, in substantially the form recommended, on June 2, 1960. The Annuity Mortality Table for 1949, Ultimate, and the Group Annuity Mortality Table for 1951 were recognized as optional minimum standards for valuation of annuities; the tables of Period 2 disablement rates and the 1930 to 1950 termination rates of the 1952 Disability Study of the Society of Actuaries were made permissive for valuation of the total and permanent disability benefits issued from 1961 through 1965 inclusive and mandatory for valuation of such benefits issued on or after January 1, 1966; and the 1959 Accidental Death Benefits Table was made permissive for valuation of accidental death benefits issued from 1961 through 1965 inclusive and mandatory for valuation of such benefits issued on or after January 1, 1966. The standard nonforfeiture law was changed so as to provide for the caluclation of adjusted premiums for policies with supplemental term coverage by separate calculation for the basic policy and for the supplemental term coverage, and to exclude from the minimum cash value calculation certain term insurance coverages on the life of a child provided in a policy on the life of a parent of the child.

Also introduced at the December, 1959 meeting was a female extension of the 1958 CSO and CET mortality tables, required to eliminate the anomalies in assumed juvenile female mortality rates which would result from a strict application of the "3-year age setback." This was adopted by the Life Committee on December 2 and by the NAIC in plenary session on December 4, 1959.

Another set of amendments was under consideration. A proposal had been adopted by the Life Committee on June 10, 1959, and duly ratified by the NAIC, that the Chairman of the Committee be authorized to appoint a subcommittee to study the need for a new industrial mortality table and an industry advisory committee to assist it. These committees, under the chairmanship of Charles C. Dubuar, Actuary of the New York Department, and William C. Brown, Vice President and Actuary, The Colonial Life Insurance Company, completed most of their work by June, 1961. After a six month period in which copies of the Advisory Committee report were distributed to each Commissioner, the NAIC Subcommittee adopted the report (with some minor technical changes proposed by the Advisory Committee) on December 4, 1961. After approval by the Life Committee, the report, with its proposed amendments to the Standard Nonforfeiture and Valuation Laws, was adopted by the NAIC in plenary session on December 7, 1961.

At the December, 1961 NAIC meeting, as a result of questions that had arisen in the valuation of coupon policies, the Life Insurance Committee decided that a Subcommittee on Reserves and Non-Forfeiture Values and Related Matters of Coupon and Similar Policies should be appointed. This new Subcommittee, chaired by Commissioner Hammel, of Nevada, concluded that the problem involved a change in the standard nonforfeiture and valuation laws, and it recommended the appointment of an Industry Advisory Committee of actuaries. The Industry Advisory Committee, chaired by Bruce E. Shepherd, addressed itself to the problem of "the tendency of some companies to use these policies of these types primarily for the purpose of obtaining the large first year expense allowances that result from liberal interpretations of the Standard Valuation Law as applied to such policies". The Advisory Committee concluded that the standard valuation law could reasonably be interpreted to impose a limit on the first year allowances for coupon policies or policies providing for increasing amounts of insurance, or both, and set forth limits which it believed the Commissioners would be justified in imposing.

The NAIC Subcommittee concluded that limitations under the standard valuation law such as were suggested by the Industry Advisory Committe"should not be effectuated unless similar limitations are applied under the Standard Nonforfeiture Law (which would require a statutory amendment thereto) and consequently should be considered only as part of some future complete review of both laws in collaboration with an industry committee set up for such purpose. At that time full consideration should be given to the effect of the proposals on other policy forms specifically designed for some social need and involving insurance which increases with policy duration, pure endowment benefits, or both." The Subcommittee also recorded doubts about other aspects of the Industry Advisory Committee's recommendation and, further, recorded views on other aspects of coupon policies, including the determination of nonforfeiture values at fractional policy durations. The Subcommittee felt that "no further progress can be made in any of the unresolved matters at this time" and requested that it be discharged. This request was granted by the Life Committee on June 9, 1965.

On June 20, 1966, ALC-LIAA presented a recommendation that the NAIC "give active consideration to a change in the standard valuation law which would make the interest rate specified for minimum annuity reserves 4% instead of 3½%." The Life Subcommittee appointed a task force, which concluded that "any change in statutory interest rate assumptions should be taken only with careful consideration of a more realistic mortality table for annuities than those now contained in the Standard Valuation Law." The task force asked ALC and LIAA to undertake studies. After a preliminary study, the ALC-LIAA withdrew their recommendation, and the NAIC took no action on it.

In 1967 the Actuary of the Wisconsin Insurance Department, Marvin E. Van Cleave, suggested that guidelines be developed with respect to any nonforfeiture provision in a health insurance policy. An Industry Advisory Committee was appointed, under the chairmanship of Jarvis Farley. In 1971 this committee proposed a set of "Guidelines Respecting the Use of Cash Surrender or Other Nonforfeiture Value Benefits in Health Insurance Policies", together with suggestions for the application of valuation standards to accident and health policies containing cash values or nonforfeiture benefits of certain types. The Industry Advisory Committee report containing the proposed Guidelines and valuation suggestions was accepted by the NAIC at its June, 1971 meeting.

On November 30, 1971, ALC-LIAA presented to the NAIC Life Insurance Subcommittee a recommendation that the interest rates specified for the minimum reserve standards for life insurance and annuities and for the calculation of minimum cash values and nonforfeiture benefits for life insurance policies be increased, and that new mortality tables be adopted for the minimum reserve standards for annuities. The Subcommittee requested that ALC-LIAA furnish a copy of its study, tables, and recommendation to each state and directed that a Valuation Task Force of department personnel be appointed.

The Valuation Task Force recommended that the interest rates be increased to 4% (rather than 4¼% as ALC-LIAA had recommended) for individual deferred annuities, for all life insurance and benefits supplementary thereto, and for health insurance, and to 6% (as ALC-LIAA had recommended) for group annuities and single premium immediate individual annuities; that the two proposed new mortality tables be adopted for group and invididual annuities, respectively; that the operative date(s) of the changes be as elected by the company, but no later than January 1, 1979; and that the new, higher interest rates revert automatically to 3½% as of December 31, 1985.

The report of the Valuation Task Force was unanimously adopted by the Subcommittee on December 5, 1972, and was adopted by the NAIC in plenary session on December 8.

EXHIBIT 2

Valuation and Nonforfeiture Value (C3) Task Force
Milwaukee, Wisconsin
August 14, 1974

The NAIC Life Subcommittee (C3) Task Force on Nonforfeiture and Valuation Regulation met at 9 a.m., August 14, 1973, at the Marc Plaza Hotel, Mwlwaukee, Wisconsin.

Representing the Task Force were:

John O. Montgomery, California, Acting Chairman
Thomas J. Kelly, New York
Ted Becker, Texas
Commissioner Stanley DuRose, Wisconsin
Brad Gile, Wisconsin
Marvin E. VanCleave, Wisconsin

Representatives of other state insurance departments present were:

W. Keith Sloan, Arkansas
Fred Martin, Florida

Robert Dineen of the NAIC Staff was also present.

Members of the Advisory Committee present were:

R. N. Houser, Bankers Life Company, Chairman
Gary Corbett, SAFECO Life Insurance Company
Mike Jordan, Coastal States Life
Richard V. Minck, American Life Insurance Association

The items on the agenda for this meeting were discussed in the order presented.

1. A progress report by Mr. Houser on the activities of the Society of Actuaries Committee.

2. The definition of the responsibilities and membership of the various advisory subcommittees needed to work on some of the more immediate valuation problems. (If the Society Committee is not presently planning similar activities.)

3. Discussion of a proposed bulletin of the California Department applying to the valuation of life insurance policies with guaranteed premium rates varying by policy duration and life insurance policies with adjustable premium rates for a guaranteed renewal period.

4. Discussion of a paper to be presented in September at the Berkeley Actuarial Conference by John Montgomery. (A copy of this is attached as Attachment A.)

5. Discussion of the responsibilities and membership of an advisory subcommittee to consider the long range aspects of policy reserve valuation.

6. Discussion of the preparation of a historical resume of the material obtained by Mr. Minck.

7. Discussion of a more detailed report on responses to the questionnaire.

Item 1. Review of the progress of the Society of Actuaries Committee by Robert Houser.

A. The Society Committee will send material to the Task Force when authorized by the Society to do so. Proceedings of the Society Committee from its formation to and including the activities of its January 1974 meeting have been received by the NAIC Task Force and its Advisory Committee.

B. The Society Committee has until August 1974, the time of this meeting, been working primarily in the nonforfeiture value area and has decided that there is no point in completely discarding the present form of nonforfeiture value legislation and regulation.

C. However it does appear that the present nonforfeiture legislation does permit some adjustments with respect to the expense allowances permitted in the present law.

1. Presently these allowances are:

   (a) Two percent (2%) of the amount of insurance, if the insurance be uniform in amount, or of the equivalent uniform amount, as hereinafter defined, if the amount of insurance varies with duration of the policy.

   (b) Forty percent (40%) of the adjusted premium for the first policy year.

   (c) Twenty-five percent (25%) of either the adjusted premium for the first policy year or the adjusted premium for a whole life policy of the same uniform or equivalent uniform amount with uniform premiums for the whole of life issued at the same age for the same amount of insurance, whichever is less.

   (d) In applying the percentages specified in (b) and (c) above, no adjusted premium shall be deemed to exceed four percent (4%) of the amount of insurance or uniform amount equivalent thereto.

2. One set of revised allowances being discussed and tested presently is:

   (a) Reduce the 2 percent factor applied to amount of insurance to one percent (1%).

   (b) Increase the total percentage of the first policy year adjusted premium from 65% to 90%.

   (c) Nothing was said about the breakdown of the percentage of the first policy year adjusted premium and presumably only a whole life plan has been considered to date.

   (d) Nothing was said about changing the overall limit of the adjusted premium four percent (4% of amount of insurance or uniform amount equivalent thereto) to which the percentages are to be applied.

D. Three areas the Society Committee is operating in are:

1. Updating mortality and interest assumptions –

   (a) A new mortality may be recommended with the design and construction of such a table to be undertaken by another Society Committee.

   (b) A higher interest rate may be recommended.

2. For fully defined products problems as to the effect of various premium and benefit task force within the Society Committee including the study of Deposit Term and Split Life.

3. For products in the consumer interest, but not fully defined and which do not fit into the current laws, an alternative approach is being investigated which may be a retrospective method as originally suggested as an alternative for <u>all</u> products but not accepted by the majority of the Committee.

E. Specific accomplishments of the May meeting of the Society Committee in Dallas.

1. The effect of changing the nonforfeiture factors as described in Section C of this review above produced a substantial cash value increase in the early policy durations.

2. The effect on nonforfeiture values of using a modern mortality table has not yet really been tested.

3. The Committee resolved to start looking at valuation problems.

F. Accomplishments of the August 13, 1974 meeting of the Society Committee in Milwaukee.

1. Interest rates. Possibly a maximum of 4½% interest rate in the calculation of nonforfeiture values may be recommended. There is some sentiment for not recommending a specific maximum. (This would merely shift the responsibility for such a decision to the NAIC Task Force whose members really have that choice to make ultimately in any event.)

2. A report to the Society of Actuaries Board of Governors was prepared which will be released to the NAIC Task Force with the approval of the Board of Governors of the Society.

3. No member of the committee wants rate regulation with respect to the gross premium minimum nonforfeiture value relationship.

4. A discussion without resolution was undertaken as to whether a variable set of minimum values should be tied to interest rates, or whether just one set should be recommended.

5. Also discussed without resolution was the revision of the Standard Nonforfeiture Law.

6. A preliminary discussion of the Standard Valuation Law covered:

   (a) The purpose of the law.

   (b) Whether or not solvency is really protected.

   (c) A definition of solvency.

   (d) Problems arising from improper matching of assets with reserve requirements, and from the deterioration of assets and/or their earning power.

   (e) The problem of deficiency reserves.

G. The Society Committee decided not to ask for access to the Hart Committee (U. S. Senate) files since those files were not in a form that could be used. (No interest or other bases for the calculation of values were listed.)

H. On the 58 CSO Mortality Table basis, the first visible cash surrender values are set at, or extremely close to, the minimum in 50% of the companies tested by Bankers Life and Casualty of Iowa using Best's 1974 Flitcraft Compend at Age 45 for ordinary life for early cash values only. The size of the company was not a factor.

Item 2. Definitions of the responsibilities and membership of the various advisory subcommittees needed to work on some of the more immediate problems.

A. Advisory Subcommittee on Immediate Problems.

For the present, it has been decided not to activate this subcommittee. Some problems are:

1. Premium deficiency reserves.

2. Reserves carried for renewable term insurance and other scheduled variable premium or scheduled variable amount plans.

3. Reserves and nonforfeiture values for general account index related products.

4. Revision of expense assumptions in nonforfeiture value regulation.

5. Special plans such as Split Life, Deposit Term.

B. Advisory Committee on Valuation and Nonforfeiture Value Regulation with Respect to Separate Account Indexed Products. (Including Variable Life, Variable Annuities, and other index related products.)

Unless the Task Force role is expanded so as to become a Task Force or Technical Subcommittee of the NAIC Life, Accident and Health (C) Committee, there is not enough authority for the Task Force to form this advisory subcommittee since the present Task Force reports only to the Life Insurance (C3) Subcommittee while the work of the Advisory Subcommittee recommended here should, under the present jurisdictional arrangement, be reported to the Variable Life and Variable Annuities (C4) Subcommittee. It is the position of this Task Force for the (C3) Subcommittee that all Valuation and Nonforfeiture regulation matters should be under the jurisdiction of one Task Force or Technical Subcommittee so as to properly coordinate a consistent approach among all such efforts.

The advisory subcommittee on Valuation and Nonforfeiture Value Regulation with respect to Separate Account Indexed Products should be comprised if possible of some of the members of the Task Force and Advisory Committee which prepared the Variable Life Model regulation for the NAIC. The specific assignment for this committee is yet to be determined but should include the coordination of separate accounts with any alternate valuation system that might be proposed for life insurance.

C. Advisory Subcommittee on the Valuation and Nonforfeiture Value Regulatory Aspects of Health Insurance.

Like the Separate Accounts Advisory Subcommittee, unless the Task Force role is expanded to encompass the entire jurisdictions of the Life, Accident and Health (C) Committee, there is insufficient authority at present for the Task Force to form this Advisory Subcommittee since the present Task Force reports only to the Life Insurance (C3) Subcommittee while the work of the Advisory Subcommittee recommended here should under the present jurisdictional arrangement be reported to the Accident and Health (C1) Subcommittee. It is the position of this Task Force, as it was with the Advisory Committee on Separate Accounts, that all valuation and nonforfeiture value regulation matters should be under the jurisdiction of one Task Force or Technical Subcommittee so as to properly coordinate a consistent approach among all such efforts.

This Advisory Subcommittee should consider the cash value benefits and attempt to devise some model nonforfeiture regulations with respect to them. Later it should coordinate the valuation of health insurance with any alternate valuation system that might be proposed for life insurance.

Item 3. Discussion of proposed bulletin of the California Department applying to the valuation of life insurance policies with guaranteed premium rates varying by policy duration and life insurance policies with adjustable premium rates for a guaranteed renewal period.

From suggestions made at the meeting and received from members of the California Insurance Department Actuarial Advisory Committee, some further changes have been made.

Item 4. Discussion of a paper to be presented in September at the Actuarial Conference on Credibility at Berkeley by John Montgomery.

A copy of the paper as presented September 19th is attached to these minutes as Attachment A.

Harold Bittell, in commenting on the draft of the speech, questioned the first sentence of Paragraph 9 relating to the statutory reserve system as to the inclusion of "expense and taxes" as items to be provided out of the funds set aside as statutory reserves. This prompted revision of the speech to read:

> The statutory reserve valuation system for life and health insurance companies in the United States has been designed, together with the conservative interest, mortality and/or morbidity assumptions associated with such a system, with the intent of providing a conservative estimate of funds needed to provide for all possible future claims, expenses, taxes and adverse contingencies.

The incidence of expense of course is not provided for but the conservative assumptions should provide for such items if a sufficiently large block of insurance is considered.

Item 5. Discussion of the responsibilities and membership of an Advisory Subcommittee to consider the long range aspects of policy reserve valuation.

A. Responsibilities of the Advisory Subcommittee on the Long Range Aspects of Valuation Regulation.

1. Area to be covered.

(a) All life insurance not included in the charges of the Advisory Subcommittee on Separate Account Indexed Products.

(b) All annuity forms not included in charges of the Advisory Subcommittee on Separate Account Indexed Products.

2. The Advisory Subcommittee should determine what alternate forms of valuation should be studied.

3. For each alternative:

(a) Develop the theoretical background in a form for regulation including the preparation of a risk theory model or models.

(b) Test each theory or alternative method to be considered.

B. Prospective Membership of the Advisory Subcommittee on the Long Range Aspects of Valuation and Regulation.

Because of the magnitude of the work expected of this advisory subcommittee, it is expected that it should number between 15 and 20 with the work being subdivided into various task forces.

Item 6. Discussion of the preparation of a historical resume of the material obtained by Mr. Minck.

This has been accomplished and is presently being circulated to Members of the Task Force and Advisory Committee.

Item 7. Discussion of a more detailed report on responses to the questionnaire.

The ALIA is working on this.

Non Agenda Items.

A. A mailing list was requested by Robert Houser. This has been sent.

B. A bibliography of materials was requested. Nothing has been done on this.

C. A companion Advisory Committee to Study the Long Range Aspects of Nonforfeiture Legislation was discussed.

It was decided not to activate such a subcommittee at present. It is possible that the Society Committee may be able to function in this capacity.

D. Comments by Mr. Dineen.

1. In years past, there has been criticism of state regulation, sometimes by the press and sometimes by legislators, about the practice of the commissioners of placing too much reliance on industry solutions to regulatory problems. In recent years as commissioners and staffs have done more and more of their own work, this criticism has been largely muted.

2. The separation of regulatory committees or task forces from advisory committees made up entirely or partially from industry-employed members is essential to the minimizing of such criticism.

3. Drafts of model legislation or regulation should be solely the responsibility and work of the task force. On the other hand, all interested groups should be encouraged to supply input towards the solution of these problems. Furthermore, they should understand that before any model legislation or regulation is adopted, all interested parties will be given a full hearing and the opportunity to make suggestions or proposed changes.

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EXHIBIT 2 – ATTACHMENT A

What Has Statutory Valuation in the United States
to do With Credibility and Risk Theory?
by
John O. Montgomery
California Department of Insurance

1. The answer to this question at the present time is absolutely nothing! There is really no aspect of the present statutory valuation system in the United States that in any way involves the use of credibility or risk theory as has been developed over the past few decades. So what am I, as Chief Actuary for the California Insurance Department and the working Chairman of the National Association of Insurance Commissioners' Task Force to review the status of Valuation and Nonforfeiture legislation and regulation, doing here? Frankly, this is going to be an appeal for assistance.

2. First for those of you who have not been attending meetings of the NAIC (National Association of Insurance Commissioners), that body designated a Task Force in December 1973:

a. To review valuation and nonforfeiture value legislation;

b. To determine the nature of problems currently encountered and recommend practical solutions which can be implemented now; and finally

c. To consider the fundamental purposes of statutory regulation, to make studies of systems alternative to the present using theories and techniques not previously available, and eventually to recommend some course of long range development of statutory regulation.

3. Nearly a year previous to the naming of the NAIC Task Force the Society of Actuaries appointed a "Special Committee on Valuation and Nonforfeiture Laws" to study somewhat the same area. After considerable discussion and investigation that committee decided first to concentrate on the nonforfeiture value problems and is soon to come forth with recommendations.

4. It is intended that there be a close liaison between the NAIC Task Force and the Society of Actuaries Committee to avoid duplication of effort and to exchange findings and ideas. However, the NAIC Task Force will retain its own advisory

committees, some members of which may also be members of the Society Committee. This will enable the Society Committee to function as a truly independent body whose members are serving as individual professional actuaries and not as representatives of their employers or clients.

5. As presently organized the Advisory Committee to the NAIC Task Force consists of five members representing various actuarial spheres of influence:

Robert Houser, for the Society of Actuaries (also a member of the Society Committee)

Gary Corbett, for the American Academy of Actuaries

Richard Minck, for the American Life Insurance Association (The ALIA is represented on the Society Committee by John Booth)

Michael Jordan, for the National Association of Life Insurance Companies

James Hickman, for the academic community

6. Currently the Task Force, comprised of representatives from California, New Jersey, New York, Texas and Wisconsin is in the process of naming some advisory subcommittees to handle the more immediate problems. By December we hope to have the ground work laid also for the more extensive long range studies to be made and to be able to ask for advisory subcommittee help.

7. Since we are very much in the formative stages, anything said here about possible future plans will be subjected to many hours of discussion and much revision before any report or recommendations can be made. This paper includes some of the material presented to the NAIC in June and some observations gleaned from subsequent discussions and readings.

8. I mentioned earlier that this was an appeal for assistance. This help is needed in handling some of the long range problems that continue to disturb the solvency and equity aspects of statutory valuation regulation of life and health insurance companies in the United States. Indeed, some of these problems may also be evident in statutory valuation regulation for other lines of business, but for this presentation only life and health insurance are to be considered.

9. The statutory reserve valuation system for life and health insurance companies in the United States has been designed, together with the conservative interest, mortality and/or morbidity assumptions associated with such a system, with the intent of providing a conservative estimate of funds needed to provide for all possible future claims, expenses, taxes and adverse contingencies. In the recent experience it has been observed that companies are still becoming insolvent, primarily from improper evaluation and matching of assets which are necessary to support the reserve required by the statutory system. In some other situations the reserves required have been such that in the light of either present experience or possible future adverse contingencies, the premiums charged the policyholder are artificially inflated.

10. Other problems with the current valuation legislative, and regulatory system, and its limitation to policy reserves, which the Task Force has identified are:

a. The present system ignors the variation of the credibility of experience with respect to the number and relative magnitude of the separate risks assumed with respect to investment, mortality and morbidity.

b. The present system ignores the effect of reinsurance in spreading risk.

c. It is difficult under the present system to reflect adequately changes in mortality, morbidity, expenses, interest rates or other factors involved in the operations of an insurance company.

d. To obtain earnings comparable to those reported for companies in other industries requires adjustment to the present system.

e. The present system is not readily adaptable to products of an index related nature.

11. Turning to the other side, the relative simplicity of the present system dominates all other considerations, and the excellent solvency record of companies using this system with appropriate and conservative premium rates and dividend scales has given the system a reputation for providing a strong basis for solvency. The current system recognizes only three parameters:

- a. Interest;
- b. Mortality and/or morbidity; and
- c. The various modified reserve systems which make some provision for expenses.

12. The simplicity of the present system is in:

- a. Its relative ease of examination and regulation.
- b. The facility for the passage of legislation for changing the dimensions of various parameters provided bv such simplicity.
- c. The generally well established mathematics for calculating statutory reserves required by this system for traditional insurance products.
- d. The well defined parameters used which depend as little as possible upon individual judgement of those making such valuations.
- e. The individually identifiable status of the reserves developed by the system.

13. What then should be considered for any alternative policy reserve valuation system to be used for regulatory purposes?

- a. The system must be readily susceptible to adequate regulation. Reserve formulas, theories or developments must be carefully explicit and understandable to the regulatory technicians who will be using them.
- b. The variation of credibility of experience with the number and relative magnitude of the separate risks assumed should be recognized. These separate risks are not only those involving mortality, morbidity or other claim losses, but also those involving investments and possibly even expense, tax and persistency fluctuation. Reinsurance is a vital part of this recognition.
- c. The assumptions for the various parameters of valuation must fall within certain well defined limits which may be broader or include more parameters than those now permitted by the present valuation statutes and may vary with the credibility of experience for each company.
- d. The assumptions used for the various parameters required by the system should be based on the most reasonably expected values of those parameters with an adjustment or additional value to take into account the chances of deviation from those expected values.
- e. For companies with credibility falling below established limits, industry average assumptions for the various parameters should be required.
- f. The present statutory valuation reserve system should be continued until any alternate valuation system has been carried along on a parallel operation for a sufficient length of time to develop a reservoier of reliable and intimate knowledge of the operation of the new system until it is possible to develop a reliable set of industry wide assumptions which could be used by companies not meeting the credibility tests.
- g. When the assumptions used in a valuation vary, or when the form of the valuation itself varies, from one year to the next the effect of such changes must be determined and shown separately (as part of Exhibit 8A, and in the Surplus Account for Life insurance, and as a separate reported item in the Surplus Account for health insurance).

14. What types of alternative regulatory valuation systems appear possible? Two approaches to this question are, first, through a gross premium valuation system with appropriate recognition of the chance of deviation from expected values for the various assumptions, and, second, through the development of statistical models by which the various assumptions for each company may be tested to develop the probabilities of ruin and to determine what reserves are needed to keep these probabilities within a defined tolerance level.

a. Under the gross premium valuation method the recognition of the chance of deviation from expected assumption values may either be developed as a set of contingency reserves separate from the gross premium valuation reserves based on expected assumptions, or the expected assumptions may include such recognition thus requiring the presentation of only one set of reserves. The gross premium valuation would be defined as the present value of all future guaranteed benefits including nonforfeiture benefits and expense and tax assumptions less the present value of all future gross premiums to be received using assumptions within the credibility limits established for investment yields, mortality and/or morbidity, persistency, expenses and taxes. In any event the adjustment for the chance of fluctuation of experience greater than an established tolerance level will depend upon the definition of those tolerance levels through the use of appropriate risk theory.

b. The statistical model approach will probably require considerably more research and testing to make it a regulatory tool than would the use of the gross premium valuation approach. The statistical model approach to regulatory valuation cannot be defined specifically at present since much more research is needed to make it a practical tool.

15. The Society of Actuaries and the Casualty Actuarial Society Joint Committee on Theory of Risk has had its primary objectives to:

a. Explore alternative reserving methods which accomplish the matching of revenue and costs;

b. Demonstrate relative patterns of earnings generated by these reserve methods for selected plans and ages, and for a model company; and

c. Demonstrate the sensitivity of earnings generated by selected reserving methods for a model company to changes in certain underlying assumptions.

16. That committee's major focus has been on the earnings aspect, rather than the solvency aspect, although it is possible for solvency to be considered in some ways as a special, and perhaps limiting, condition of the earnings aspect.

17. The Society of Actuaries Committee on Research has among its various objectives those to foster research and maintain contact with current thinking in the theory of risks and in new methods of statistical analysis.

18. The NAIC Task Force intends that a close liaison should be maintained with all such committees as those mentioned in this paper.

19. In conclusion, whatever is developed must be simple enough for the non-mathematician to understand. This is probably the most demanding condition that will be imposed on any alternative valuation system. The use of expressions like "gamma function" or "Asymptotic probability" will mean nothing unless they are explicitely and simply defined. If needed they possibly could be defined without even resorting to such frightening labels to the layman.

20. Specifically some areas where we need help are:

a. For those areas where theory is now adequate to accomplish some of the tasks set forth, that theory should be re-expressed or developed in as simple a form as possible taking care not to use expressions, common to the mathematical world, which are unknown to the layman, without properly defining them.

b. The development of statistical models for insurance companies.

c. The development of theory adequate to derive expressions for the chances of fluctuation of experience from that reasonably expected for the various assumptions required in a gross premium valuation.

d. Further development of sampling techniques needed to build models from which the gross premium valuations may be constructed.

21. I realize that considerable and significant research has already been accomplished in some of these areas but nothing has been developed yet of truly practical value in insurance company regulation. Part of the difficulty has been such overwhelming confidence in the present statutory system that the idea of an alternate system has not been really seriously considered in the last century. However with increasing numbers of life insurance company insolvencies and with the growing consumer concern over the cost of insurance products, a serious investigation of statutory solvency regulation seems more needed now than at any time since Elizur Wright.

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EXHIBIT THREE

Nonforfeiture and Valuation (C3) Task Force

New Orleans, Louisiana
October 26, 1974

The (C3) Task Force on Nonforfeiture and Valuation Regulation met at 10 a.m., October 26, 1974 at the Mariott Hotel in New Orleans, Louisiana.

Representing the task force were:

John O. Montgomery, California, Chairman
William A. White, New Jersey
Thomas J. Kelly, New York
Ted Becker, Texas

Representatives of other state insurance departments were:

W. Keith Sloan, Arkansas
W. Harold Bittel, Kentucky
William R. Burns, North Dakota

Members of the advisory committee present were:

Robert N. Houser, Chairman, representing the Society of Actuaries
Gary Corbett, representing the American Academy of Actuaries
James Hickman, representing the academic community
Richard V. Minck and John Booth of the American Life Insurance Assoction

The first item discussed was not on the agenda and concerned a statement to be included in the report to the NAIC concerning the nature of the advisory committee and decided on the phrasing:

> The function of the advisory committee to the task force is to serve as a body of independent professional actuaries representing but not speaking for, various organizations.

After this discussion the agenda was followed:

I. Presentation of reports

A. The Society of Actuaries Nonforfeiture Report is to be received Monday, October 28 if possible. There was some discussion about the releasing of such reports until approved by the Board of Governors of the Society of Actuaries.

B. The report on the history of developments since the days of the Guertin Committee was received and it was voted to incorporate that report in the report to be presented to the NAIC in December.

II. Advisory Subcommittees

In the discussion of the membership and charges of these subcommittees it was decided to change their structure somewhat:

A. <u>Advisory Subcommittee on Immediate Problems</u>

The most immediate problems at the present time appear to be:

1. The premium deficiency reserves resulting from the present usage of more current interest and mortality assumption in the gross premium calculations.

2. The misuse of the "uniform percentage of gross premium for valuation net premium" rule has resulted in a number of exotic products.

3. The valuation of health insurance where for some products inflation and/or the economic cycle has played havoc with the experience so that current valuation assumptions are no longer valid.

Some of these immediate problems probably can be alleviated by the use of more up to date minimum reserve assumptions. For the present this subcommittee will not be activated.

B. <u>Advisory Subcommittee on the Long Range Aspects of Valuation Regulation</u>

After considerable discussion this subcommittee was restructured. Concern over the compatability of valuation approaches for the various lines of insurance even though such approaches must necessarily have distinctive features which will vary by line, have prompted the formation of a subcommittee to consider the general approach and the variations of such approach for each line of life insurance and annuities, with later branches of the subcommittee to consider the variation of the general approach for health insurance, separate account business, and possibly even fire and casualty lines.

These later variations in approach are possible only if the role of the Task Force is broadened to include possibly all lines. This is possible if the task force is expanded to become a special technical subcommittee to the Executive Committee with the charge of examining valuation and nonforfeiture regulation.

If such expansion of the role of the task force is permitted by the NAIC, then the present subcommittee should include some members who will be knowledgeable in other lines of insurance. This is needed to assure compatability in approaches and to provide a channel of communication with those actuaries active in other lines of insurance.

1. The structure of the Advisory Subcommittee on the Long Range Aspects of Valuation Regulation will consist of two types of members:

   a. Working members.

      These are expected to be able to furnish facilities and considerable help in testing the various reserving approaches developed.

   b. Resource members.

      These members either have some special talent or knowledge or are familiar with a special actuarial sphere of activity or both. They will be expected to make that special knowledge available and provide review and comment with respect to the various phases of the research.

2. The responsibilities of the Advisory Subcommittee on the Long Range Aspects of Valuation Regulation cover:

   a. Are to be covered.

(1) All life insurance including that associated with separate accounts, if the NAIC approves an extension of authority of the task force.

(2) All annuity forms including those associated with separate accounts if the NAIC approves extension of authority of the task force.

(3) For any or each other line of insurance (if approval of expansion of the role of task force is made by the NAIC) a separate sub-task force of the advisory subcommittee will be formed to provide the adaptation of the reserve approach to that particular line of insurance.

(Note: At this point in the discussion it was observed that the president of the Casualty Actuarial Society should be contacted for the name of a couple of potential subcommittee members who were casualty actuaries.)

b. The advisory subcommittee should determine what problems are arising with the present valuation system and what impact the assets portfolio has on the adequacy of the reserve system to measure and maintain solvency.

c. The advisory subcommittee should determine what alternative forms of valuation should be studied.

d. For each alternative:

(1) Develop the theoretical background in a form for regulation including among other approaches the preparation of a risk theory model or models.

(2) Test each theory or alternative method to be considered.

3. The membership of the advisory subcommittee as of this date consists of tentatively:

Chairman: Edward A. Lew who will function primarily as a resource member.
Vice Chairman: Richard S. Robertson who will function as a working member.

a. The working members are:

John K. Booth, ALIA
John M. Bragg, Life Insurance Company of Georgia, President-Elect of the Society of Actuaries
Frank P. DiPaolo, Confederation Life Insurance Company
Don B. Maier, Metropolitan Life Insurance Company
Robert C. Winters, Prudential Insurance Company
Reginald O. Yoder, Bankers Life & Casualty Insurance Company
Richard W. Ziock, Continental Assurance Company

b. Resource members include:

Thomas T. Chamberlain, Montgomery & Chamberlain
Russell M. Collins, Jr., J. C. Penney Insurance Company
Abraham Hazelcorn, Coopers & Lybrand, N. Y.
Richard B. Horn, Security Life & Accident Insurance Company
Jay M. Jaffe, Jaffe and Associates
Lawrence Mitchell, Mitchell and Kadoyama
John S. Ripandelli, Consultant
William David Smith, Milliman & Robertson, S. F.

Before the report is made in December it is hoped that this list can be made more complete. Yet to be named also are the liaison members with other lines of insurance other than general account life insurance.

4. In the initial phase of the work of the advisory subcommittee questions to be answered are:

   a. Where are we now with respect to valuation regulation?

   b. What projects are feasible now and what projects must wait until the theoretical considerations have been clarified enough to make a practical approach to the problem?

   c. What time span should each project cover?

5. The time frame for the operations of the advisory subcommittee contains the following important dates:

   a. Approval of the formation of the advisory subcommittee should be given in December.

   b. The first meeting of the advisory subcommittee should be in January.

   c. The Blanks (A1) Subcommittee is meeting in San Francisco in April and many persons involved will be traveling to that meeting.

   d. The NAIC will meet the first week in June at Seattle.

   e. The Society of Actuaries annual meeting is in Miami on October 20-22.

   f. The NAIC will meet the first week in December in San Juan, Puerto Rico.

   These dates are important because some of the meeting dates of the subcommittee could be timed to coincide with them to ease the strain of travel expense. The subcommittee probably should <u>not</u> meet in conjunction with an NAIC meeting if it expects the results of its meeting to be reported at that time. It must give the Task Force at least a month to review its findings before reporting them to the NAIC.

It is expected that the Society of Actuaries' Committee on Valuation and Nonforfeiture Laws will also review the findings of the NAIC Advisory Subcommittee on the Long Range Aspects of Valuation and report to the Board of Governors of the Society. The NAIC will welcome and consider the review by that committee if the Board of Governors authorizes the transmittal of such a report to the task force.

C. <u>Advisory Subcommittee on the Long Range Aspects of Nonforfeiture Value Regulation</u>

This subcommittee also appears needed and will be set up after the task force has reviewed the final report by the Society of Actuaries' Valuation Committee. Sub-task forces of this subcommittee are also needed for separate account business and health insurance if the role of the task force is expanded by the NAIC.

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EXHIBIT FOUR

Nonforfeiture and Valuation (C3) Task Force

New Orleans, Louisiana
October 28, 1974

The (C3) Task Force on Nonforfeiture and Valuation Regulation met again in New Orleans at the Mariott Hotel at 4:30 p.m., October 28, 1974.

Representing the task force at this meeting were:

John O. Montgomery, California, Chairman
William A. White, New Jersey
Thomas J. Kelly, New York
Ted Becker, Texas
Marvin Van Cleave and Brad Gile, Wisconsin

Representatives of other state insurance departments were:

W. Keith Sloan, Arkansas
William P. Burns, North Dakota

Robert E. Dineen of the NAIC staff was also present.

Representing the advisory committee were:

Robert N. Houser, Chairman, representing the Society of Actuaries
Gary Corbett, representing the American Academy of Actuaries
James Hickman, representing the academic community
John K. Booth and Richard V. Minck of the American Life Insurance Association

The function of the advisory committee to the task force is to serve as a body of independent professional actuaries representing but not speaking for various organizations.

The first and only item on the agenda for this meeting was the presentation by Mr. Houser of a description of the proceedings of the meeting of the Society of Actuaries Special Committee on Valuation and Nonforfeiture Laws on October 27, 1974. No formal report is yet available from that committee and it appears that it will be six to eight months before such a report will be forthcoming. The notes presented by Mr. Houser are attached.

A significant development in the proceedings was the decision of the Society Committee to wind up its work on nonforfeiture values as soon as possible (six to eight months) and request that the committee be reconstituted to serve as an advisory committee to the NAIC task force, yet still report through the Board of Governors of the Society. The Board of Governors confirmed this decision by accepting the committee's recommendation.

Aspects of this development occupied the remainder of the meeting. The task force then dismissed the advisory committee and went into executive session, during which the matter of the dual responsibility of the proposed committee and the possibility of conflict of interest was aired. The meeting was interrupted at 6:30 p.m. when the room was ordered vacated for a reception which was to occur there; therefore, no decision was made.

Before closing it was agreed that the members of the task force would submit to John Montgomery as soon as possible their ideas on the rules of advisors and the course of action to be taken.

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Society of Actuaries'
Meeting of October 27, 1974
Notes by Robert N. Houser

Spent better part of meeting discussing future direction of the committee. Executive Committee of the Board of Governors feels that committee should wind up nonforfeiture work as soon as possible and move on to valuation area.

Consensus of committee was that it makes no sense to start work on valuation problems at same time as advisory subcommittee to NAIC task force is being formed to tackle same subject. This is particularly true since advisory subcommittee will be made up primarily of Society members including many of those knowledgeable in risk theory. For the present Society Committee to undertake this same project, it would have to be expanded to include some strong risk theorists.

The only problem in deferring completely to the NAIC advisory subcommittee was feeling that Society would likely want some definite input and feedback through an officially designated Society committee responsible to the Board of Governors. Best answer would seem to be to request Board to form such a Society committee and then recommend to the NAIC task force that they be accepted as members of the advisory subcommittee. In keeping with this thought, the following recommendation to the Board was approved by the committee:

> The committee recommends: that the Society of Actuaries appoint a committee to represent the Society of Actuaries in any study of valuation matters; that the members of this new committee be recommended to

the NAIC as members of the appropriate NAIC advisory group; that this new committee be responsible to report on its activities to the Board of Governors; that the charge to the existing committee to study nonforfeiture and valuation laws be changed to be consistent with the charge to the new committee; and that the existing committee to study nonforfeiture and valuation laws be asked to complete its report on nonforfeiture matters as soon as possible.

Remainder of the meeting was devoted to plans for winding up work on nonforfeiture values. Final report should be comprehensive as to avenues explored by the Committee. Should cover not only conclusions and recommendations of the committee but also ideas or concepts studied and rejected by the committee, together with supporting reasons.

Should also include detailed committee work on specific nonforfeiture problems, although these will likely be in form of appendices to the report. Report will not try to develop nuts and bolts of any necessary changes in law to implement committee recommendations. This detail is better left to others. John Gardner will prepare an outline of final reports with assignment to specific individuals to flesh this out. The report will be discussed in detail at December meeting. Hope to complete final report within six to eight months even if some details are left unfinished.

Note: It was later reported that the Society's Board of Governors accepted the committee's recommendation 100%.

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EXHIBIT FIVE

To: John Montgomery, Chief Actuary
California Insurance Department

From: LaMar Walker, Actuary
Utah Insurance Department

Date: June 20, 1974

For your consideration and consideration of the Task Force on Standard Nonforfeiture and Standard Reserve Valuation Laws, I have enclosed copies of two policies.

The first policy is a paid-up at age 65 health and accident policy with no benefits other than return of premium at death before age 65, unless such death is by suicide in which case no benefits are payable! Ignoring the fact that this policy should not have been sold with such a suicide clause in the first place, it is still a health and accident policy that will necessitate the building of reserves during the premium paying period.

The second policy is a whole life policy with reserves based on the 1958 CSO table and a 0% interest assumption. This policy was initially presented to the Department as a "nonparticipating policy" with "excess interest distributions". Obviously, as it was argued, since an insurer assumes he will earn no interest on the investment of reserve money, any that the insurer does earn would be available to distribute as "excess interest". It was also argued that an insurer has historically reserved the right to pay excess interest on settlement options, so why not establish the same right on the policy and hence step around any dividend implications.

This latter argument is further supported by a type of nonparticipating policy which is currently being issued in many States, wherein a policy rider (or provision) allows a policyholder to deposit money in a fund held by the insurer which pays a guaranteed 5% interest for ten years and 3% thereafter; and the insurer maintains the right to pay excess interest. As a matter-of-fact, one such insurer is currently paying 7% on such a fund!

As you will note the whole life policy has been modified since it was initially presented; it is now called a participating whole life policy with dividends. But the 0% interest rate remains, which raises the question: should the Standard laws require a minimum interest rate?

Any critical comments with whom you come in contact may have, will be appreciated.

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To: John Montgomery, Chief Actuary
California Insurance Department

From: LaMar Walker, Actuary
Utah Insurance Department

Date: August 22, 1974

There are several types of funds established by provisions in life policies into which policyholders may contribute and receive a guaranteed rate of interest return. These funds include premium deposit funds, dividend accumulations, endowment accumulations, retirement deposit funds, coupon accumulations, etc. Currently guaranteed rates of return run from values of 2¼% or lower up to 5% or higher. Five per cent has been common on premium deposit funds for some time, but recently, rates of 5% have been guaranteed for retirement deposit funds and others.

I was recently queried as to any objection I might have for a guaranteed rate of 7% on a retirement deposit fund; and of course, the ridiculous is being approached!

The questions can now be put: Can an insurer guarantee a rate of return in excess of the 3½% (4% for annuities) valuation rate, and if so, should a reserve for such excess be required?

There are arguments pro and con a reserve.

Con: The fund is not a "life insurance benefit" and hence is not subjec to basic valuation rates.

Pro: The fund was established by policy provision and guaranteed by the insurer.

Obviously, if prime rates dropped to 5% or lower a guaranteed (policy benefit) rate of 7% or even 5% might jeopardize the insurer's ability to meet its primary commitments.

If "x"% is assumed to be a "safe" rate of investment return for invested company assets, then it seems a little silly for an insurer to guarantee its policyholders a rate of interest in excess of "x"% on accumulation deposit funds. This is not necessarily true on premium deposit funds where a real savings to the insurer can be demonstrated; nor is it true for the "backhanded" way of paying high interest rates by loading the basic premium.

I will certainly appreciate any responses you may have to the basic question of "reserve for guaranteed interest in excess of 3½%".

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To: John Montgomery, Chief Actuary
California Insurance Department

From: Keith Sloan, Life Actuary
Arkansas Insurance Department

Date: October 30, 1974

This will set out my thoughts as to some of the items discussed or implied by the discussion in our unfortunately interrupted meeting, as well as ranging a little further afield in directions I propose to develop. I still believe that attempting to give any advisory subcommittee specific assignments at this time is premature, and the Society's attitude, as expressed, or at least as I understood it, has served to crystallize mythinking as to need for and nature of advisory groups. I thoroughly agree with Bob Dineen that the Task Force must lead, and not simply rubber-stamp the findings of another body, no matter how august that body might be.

In other words, as Bill White put it, these are not industry problems, but regulatory ones. The most we can ask an advisory group to do, and preserve our own independence, is to evaluate the effects of proposed changes, indicate feasibility (though we must reserve the proverbial grain of salt), and make any other suggestions they as interested professionals may wish to make.

Accordingly, our report should summarize the development of our thinking on the topics reported in San Francisco, and should request:

1. Designation as a technical task force or subcommittee if appropriate of the (EX) Committee.

2. Request permission to set up advisory committees as needed, each to report to the Task Force.

3. Request authority to request, as needed, through the Central Office, that the Society of Actuaries, or any other appropriate body or entity, perform specific studies when they become defined.

This is a very broad request, and would understandably require support. I think you are cognizant of my reasons for the first request, but they are:

1. The subject of solvency is not peculiar to life or health insurance. A free-ranging committee could have impact on and draw from the experience of persons in other lines.

2. This is a long-range project, requiring a degree of continuity of membership of the professional persons involved.

3. Such a committee could function as a technical task force of many existing subcommittees without the need to go through motions of setting each up on an ad hoc basis.

My other suggestions are also broad. I see the need to set up the advisory committee we proposed in the October 26 meeting, with a charge as broad and a specific assignment as narrow as are shown in the minutes of that meeting. I believe we must, however, refine the Task Force's thinking before we can make effective use of a Society committee. We will apparently get much better results from specifically requested projects than from broad-based ones. The NAIC advisory committee can, however, be taking a general look in parallel with the Task Force. I would suggest, however, that each actuarial organization (Society, Academy, Consulting Society, Conference) be asked to provide a liaison person to the NAIC advisory committee.

We also need to meet sometime without advisors of any sort. With the material already in our hands we can draw some preliminary conclusions and we must wrestle with the real nature of the problem ourselves since only we can wrestle with the nature of regulatory problems.

As I see these problems, we are faced with at least two major ones which underlie anything anyone does. In the nonforfeiture value situation, it appears the Society committee has reached a virtual stalemate at the question "What is equity?" As to valuation, we must at some stage define "solvency". There is, in addition, the unfortunate use of words in the past, and the very damaging evidence in the Hart "Green Book", which indicates that somewhare along the line the gross premium and its assumptions are going to have to be taken into account.

I have some pretty specific ideas as to how some of these can tie in which I will try to get to you in very rough form between now and Mexico City.

Again, I am going to urge that somewhere along the line we take advantage of the fact that Arkansas does have an expert on risk theory. Ken McIntosh was one of the CAS representatives on the original joint committee and is limited only by his lack of firsthand knowledge of what he calls the "real world problems" in life insurance. As a matter of fact, if the trend formula referred to in passing by Bob Dineen is what it sounds like it might be, Ken will probably demolish it in about as long as it takes him to write out the paper doing so. There's also the model described in the material Bob Houser sent us, which needs to be evaluated, and I saw an ad last week for a book which could be of use. It costs $25.00 but I guess I can stand one more expense.

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To: John Montgomery, Chief Actuary
California Insurance Department

From: C. F. B. Richardson, Chief Actuary
Tennessee Insurance Department

Date: November 13, 1974

Subject: Deposit Term Insurance

As you are no doubt aware, Deposit Term Insurance was studied by a Task Force of the NAIC which made a report at the meeting of June 19, 1974, requesting that certain aspects of this product be considered by (a) the Task Force on Standard Nonforfeiture and Standard Reserve Valuation laws, (b) the Subcommiteee on Insurance Advertising Regulation and (c) by the Task Force on Life Insurance Policy Lapses. The product appears to be subject to certain abuses, which are now coming to our attention. We would like to know what action may have been taken or is being contemplated by other insurance departments.

Enclosed is a copy of an order of our Department dated April 24, 1973, which gives a certain degree of control but does not deal with all of the problems involved. We would appreciate your answers to the following questions:

1. What, if any, special requirements or regulations have you adopted in regard to this product?

2. What special practices have you followed in reviewing policy forms?

3. Have you required, in determining the minimum policy values, that the contract must be treated as an endowment maturing at the end of the term period and not as a modified premium whole life policy in cases where the term contract is followed by a whole life policy?

4. Have you approved such contracts for a term period of more than 10 years, e.g. 20 years, where the endowment can be as large as $50 for a deposit of $10?

5. Have you approved contracts under which the initial term period may be followed by an additional term period with an additional deposit and at the end of such additional period, possibly followed by automatic continuation as a whole life policy? In such contracts, how have you applied the minimum nonforfeiture value requirements?

6. Have you observed any evidence that deposit term is particularly susceptible to misrepresentation and in particular has given rise to complaints in regard to twisting and replacement of existing permanent insurance? We have had such an experience.

7. Do your statutes contain a provision which would require a demonstration that the term insurance coverage under this product must be self-supporting?

8. Have you considered that the product may be illegal because it violates the "entire contract" principle in the law and that it is a tie-in sale?

Please accept our apologies for the length of this letter, but we feel that this product presents real problems to the regulatory authorities and would like to be informed on current practices.

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To: John Montgomery, Chief Actuary
California Insurance Department

From: Keith Sloan, Life Actuary
Arkansas Insurance Department

Date: November 13, 1974

I was asked a question today which should be faced by the Valuation Task Force as an immediate problem. As a matter of fact, I think the company who asked intends to bring the subject up, but I'm not sure at which committee or subcommittee.

This has to do with the transition to 4% reserves, which is beginning to be felt in some states. The trouble is that fewer than half the states have adopted the revisions to the valuation law, and companies operating in states where this has been done for long enough periods to produce an effect on total reserves are concerned as to what to do in states where the statutory maximum is still 3½%.

I suggested that for Arkansas, a separate certification might be the answer, but it seems desirable that some agreement be reached so that the various states at least know what they're looking at.

Do you suppose we can get some sort of consensus at Mexico City on this?

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To: John Montgomery, Chief Actuary
California Insurance Department

From: Ted Becker, Managing Life Actuary
Texas Insurance Department

Date: November 18, 1974

This will acknowledge receipt of your letter of October 31. I do expect to be present at the Task Force Meeting on Monday afternoon, December 2, in Mexico City. My plans are to arrive in Mexico City on Sunday, December 1. I will be staying at the Maria Isabel Sheraton Hotel, sharing a room with Mr. Woody Pogue of our Life Division.

The remainder of this letter is a list of my comments on the preliminary work of the committee, and its future course. I am sorry that I was not able to furnish these comments more promptly.

1. The plan to have the Advisory Subcommittee work directly under the Task Force (rather than as an arm of the Society of Actuaries) seems to me to be a good one. I understand that Mr. Ed Lew is agreeable to this plan.

2. The Society of Actuaries should be able to send one or two representatives to the Advisory Subcommittee meetings as monitors. Such monitors would report to the Board of Governors of the Society, and the Board of Governors could directly contact the Task Force, if it deemed this advisable.

3. It is imperative that the Advisory Subcommittee have members who are not representatives of insurance companies. I believe the suggestion that at least two professors, representing the academic community, be included in its membership is an excellent one. This should relieve some of Mr. Bob Dineen's fears that it would look like the insurance industry is writing its own ticket.

4. A major purpose of the Advisory Subcommittee is to get a wide variety of ideas, and I tend to favor a large membership consisting of virtually all competent persons who are willing to serve. It is understood that a large membership might perhaps be unwieldy, but I believe the advantages outweigh the disadvantages.

5. The purpose of our Task Force, as I understand it, is to investigate various possible means of setting up adequate reserves and minimum nonforfeiture values. Therefore, I feel it is proper to study risk theory as one such possibility. I feel this study is consistent with the original purpose of the Task Force.

6. None of the states represented on the Task Force has any staff members who have practical experience with risk theory, except yourself in California. This means that the Task Force will have to rely very heavily on the membership of the Advisory Subcommittee to see that we are not "led" into the wrong conclusions. (For example, I personally had had absolutely no contact with risk theory prior to the meetings of the Task Force.)

7. In my opinion, it is premature to talk about reserves for property and casualty insurance using risk theory models at this time. We have not yet determined that risk theory is the best approach for setting up reserves on life insurance, as we know it in the United States.

8. In any event, I have the intuitive feeling that risk theory methods are not the answer for setting up proper reserves for very small companies. In these smaller companies, personal dishonesty and incompetence in company management could materially affect solvency. I do not see how risk theory models can properly recognize the full effect of such factors. The Advisory Subcommittee and the Task Force should keep in mind the question of whether its recommendations are appropriate for all insurance companies. This is an important factor in states such as Texas, where the Legislature seems to feel that the existence of a substantial number of small companies, of various types, is in the best interest of the public.

9. Since the general project of the Task Force appears to be a rather involved and time-consuming one, perhaps we should give immediate consideration to whether minor amendments in the Standard Nonforfeiture Law and Standard Valuation Law are desirable, so as to permit certain policy forms which are not contemplated by those laws and perhaps to correct problems and omissions in those laws.

10. Annuities and health insurance policies should be considered within the scope of study by the Advisory Subcommittee and the Task Force.

11. This is a further elaboration of Point 6 above, I suppose. The present staff members attending the Task Force meetings might find it easier to explain our conclusions to their Commissioners (or to their Board Members or even to Legislators of their respective states, if necessary) if the Task Force goes the route of trying to patch up and modernize the present Standard Nonforfeiture Law and the present Standard Valuation Law. Further, these staff members have considerable personal expertise in the present laws, and they have some idea how well these laws are working. In other words, I am saying that we should investigate risk theory, but perhaps the above facts deserve some practical consideration in determining our final answers.

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To: John Montgomery, Chief Actuary
California Insurance Department

From: William A. White, Chief Actuary
New Jersey Insurance Department

Date: November 20, 1974

As promised in this morning's phone conversation, this letter represents my efforts to set down an understanding of some key problems which we are encountering on the C3 Task Force to Study the Nonforfeiture and Valuation Laws. The main missing item, in my opinion, is a statement of the <u>regulatory concerns</u> which gave rise to the appointment of the Task Force.

The problem is that, in the absence of a fairly comprehensively defined assignment from us (the regulators), any advisory and technical committees on which we rely will tend to provide answers to industry problems, rather than to regulatory problems. An example of this was Bob Houser's admission, in New Orleans, that the Unruh Committee was unable to agree on a definition of "fair" as it applies to the theory of nonforfeiture values. In the absence of such a definition, any report coming from this Committee will necessarily define "fair" as it applies to the industry, and, applying the "convoy principle," industry will be characterized by the greediest company represented. It behooves us, in our capacity as regulators, to provide a definition of fairness, or a series of definitions, so that advisory committees will not waste time trying to guess at our intentions or to provide advice not suited to our objectives.

My personal suggestions can, for convenience in future discussions, be grouped into five numbered sections:

1. We must completely divorce the nonforfeiture elements of our work from the valuation elements and treat each as a separate and pressing problem. It is unfortunate that the mathematical similarity and historic overlap of cash values and reserves has caused them to be lumped together. I agree with you that it is desirable to have one group of regulatory actuaries concerned with both problems, because of the limited supply of regulatory actuaries and because the approaches to each study should involve the same sorts of procedure. Ultimately, there may have to be some sort of interrelationship between valuation and nonforfeiture minimum standards, but during the "study" phase, let's try to keep them completely separate.

2. There is always a tendency to avoid theoretical considerations and to leap immediately to practical solutions – both among industry representatives and among regulators. We are fortunate to be involved in deliberations which should have a lasting and salutary effect on the life insurance industry. Our approach should be, first, to update and develop – from a regulatory viewpoint – the general theory of our assignment and, second, to seek out practical methods for implementing this theory. The search for theoretical truths means that we cannot view our assignments narrowly, but in the broadest possible contexts.

3. Applying the preceding paragraph to our mission, in a somewhat over-simplified fashion, I see our Valuation study as an extension of the regulatory responsibility to assure solvency of life insurance companies. In the same way, our nonforfeiture study is an extension of the regulatory responsibility to assure an equitable assessment of acquisition costs against holders of permanent life insurance who voluntarily terminate their contracts. This, I believe, is the nub of the regulatory viewpoint which we have failed to define among ourselves and to communicate in our instructions to our technical and advisory committees. The following two paragraphs elaborate on these viewpoints.

4. In its broad sense, valuation applies to the measurement of all contingent liabilities of a life insurance company. This measure, combined with definite liabilities, is matched against assets to determine the degree of solvency (capital and surplus) of the company. Thus, the adequacy of valuation standards, taking account of all contingencies to which the company is subject, is of major import to regulators in their responsibility of assuring company solvency to the public.

   This implies that our assignment to study valuation standards should include the mix of business within a company, its reinsurance arrangements and other "hedges" against risk, the quality and timeliness of the company's assets, and the magnitude of random fluctuations the company may experience. To the extent that asset valuation methods are fixed, the MSVR is a contingent liability for inclusion in our study. Note also that "solvency" is a relative term requiring more precise definition by us. To illustrate: is a company with zero surplus considered solvent if valuation standards produce a "ruin probability" of 1 in 10, 1 in 1,000, or 1 in 1,000,000? Our definition of solvency should depend on our appraisal of the consequences of insolvency (taking into account such things as guaranty funds and associations), and the advice of our advisory committees should vary according to the definition. In my opinion, valuation standards that mandate grossly redundant solvency should be avoided as strenuously as standards that fail to disclose real or potential insolvency.

5. Minimum nonforfeiture standards must be responsive to the industry's (and hence, the public's), problems of poor persistency and incomplete disclosure of acquisition costs. Obviously, any set of nonforfeiture values would be acceptable (and meaningless) if permanent life insurance were 100% persistent. By the same token, net level premium reserves would be the most logical minimum nonforfeiture standards if there were no "front end load" or acquisition expenses involved with the sale of permanent life insurance. I was impressed with the statement in Tom Eason's memo on "Purposes of the Standard Nonforfeiture Law" to the effect that a good minimum law "should be coercive in its effect upon improperly managed companies . . . and persuasive upon the practices of others." We should not overlook the opportunity to coerce if nonforfeiture standards provide a method to correct life insurance shortcomings or inequities.

I see the following as crucial questions to which neither we nor the Unruh Committee have addressed ourselves:

What gives rise to the large number of early voluntary terminations on permanent policies, and whose fault is this?

Are the traditional "asset share" assumptions (namely, that all marginal expenses resulting from sale of an insurance policy are properly assessable against the insured) too readily assumed by all of us in our thinking as to maximum nonforfeiture standards?

Is the present absence of disclosure of acquisition costs and of the financial effects of early termination fair in light of the industry's treatment of terminating policyholders?

It should be evident that we can spend days discussing any of the questions raised in this letter. I hope we can arrange a meeting of the Task Force, without industry involvement, to clarify our responsibilities and define our objectives. You may find the enclosed letter and memo from Tom Eason helpful, if you have not already seen it.

Life Insurance Cost Comparison (C3) Task Force
Mexico City, Mexico
December 3, 1974

The Life Insurance Cost Comparison (C3) Task Force, convened at 2:30 p.m., in the Chapultepec Room of the Camino Real on Tuesday, December 3, 1974. A quorum was present and the meeting was chaired by S. C. DuRose who reviewed the status of the research projects authorized and described in the task force report of June 1973 (1973 Proc. II 536-538).

Research Project 1. Policy data gathered jointly with the Subcommittee on Anti-trust and Monopoly of the U. S. Senate Judiciary Committee from a representative sampling of life insurance companies. This data bank is comprised of a pricing study input file of one reel of computer tape and an output file of five reels of computer tape. Both the input and output data is also available in visual form on 49 cartridges of microfilm. The Executive Secretary's Office of the NAIC has a copy of the computer tapes and microfilm cartridges. The procedure for obtaining access to this data by NAIC members, committees, or task forces working on NAIC projects was furnished to all members of the NAIC in the May 10, 1974, letter from Johnnie L. Caldwell, chairman of the Executive Committee (1974 Proc. II 16-17).

Research Project 2. Test the results produced by different comparison methods and consider why such methods produce similar or different results. The Society of Actuaries' Committee on Cost Comparison Methods and Related Issues (Special), chaired by Bartley L. Munson, F.S.A., accepted responsibility for the project. A preliminary report was presented in June 1974. On November 8, Mr. Munson forwarded to the chairman of the task force copies of a report, "Analysis of Life Insurance Cost Comparison and Index Methods." The introduction to the report, and Mr. Munson's letter, indicate that the report was prepared by the committee in response to the request of the NAIC to do Research Projdct 2 and Research Project 9. The introduction also states that, "though, as we believe typically and properly happens with research projects, the final report may be slightly different in form or tone than was envisioned when these two specific projects were worded some sixteen months earlier, it is also our hope that this report is properly responsive to that NAIC request." Mr. Munsion's cover letter states, "if you desire any discussion or clarification of these reports, please contact me; our committee would be happy to attempt to assist in their understanding and usefulness." Copies of this report were sent to members of the task force November 13.

Research Project 3. Preparation of a report setting forth the relative advantages and disadvantages of the so-called "snapshot" and "average" approaches to policy cost comparison and to attempt to demonstrate whether these approaches produce different or similar results. Statistical information for this project was to flow from data gathered for Research Project 1. E. J. Moorhead has responsibility for this project and reported to the chairman on November 26 that the report will be delivered in January 1975.

Research Project 4. A report to consider the relative advantages and disadvantages of the "snapshot" and "average" approaches to policy cost comparisons from the point of view or needs of the buyer. The Life Insurance Marketing and Research Association accepted responsibility for this project and had previously advised that the report on this approach to the use of cost comparison information would await the result of Mr. Moorhead's analysis of Research Project 3. Robert Carlson, Vice President-Research, LIMRA, advised the chairman on November 26 that data from the national survey phase of Research Project 11 will be the basis for the report on this project which he expects will be presented to the chairman late in January 1975.

Research Project 5. A report on the extent to which the range of values within each of the cost comparison methods identified in Research Project 2 vary because of the different markets served by different companies, or policy features not reflected in the index or other identifiable causes. The American Life Insurance Association agreed to undertake this project. One of the ALIA Member companies volunteered to do a first draft of Project 5 and Mr. Minck reported to the chairman on November 27 that a first rough draft of the report has been prepared and is to be mailed to him for review over Thanksgiving. He hopes to have the first draft ready for submission to the ALIA Subcommittee on Cost Comparisons in December for consideration at a January meeting of that subcommittee. A final report should be ready in February 1975.

Research Project 6. A study of participating life insurance policies in respect to dividend scales illustrated or published 10 and 20 years ago compared with the dividends actually paid. The study would provide a commentary on the usefulness of dividend illustrations to the life insurance buyer. The Americal Life Insurance Association undertook this research project and copies of their report were distributed to members of the task force on October 8 with a transmittal letter from Richard V. Minck, Actuary, American Life Insurance Association, advising that if there were any matters to be extended or clarified he should be contacted.

Research Project 7. For a representative group of participating life insurance policies, each company will be asked to describe its philosophy in the computation and dissemination of dividend illustrations. The Society of Actuaries' Committee on Cost Comparison Methods and Related Issues (Special) also accepted the responsibility for this project. Bartley L. Munson, F.S.A., chairman of the special committee, forwarded copies of a report, "Philosophies in the Computation an; Dissemination of Dividend Illustrations," along with his letter to the chairman of the task force on November 8. Copies of the report were furnished to members of the task force with the chairman's letter of November 13. Mr. Munson, in his transmittal letter, suggested that if the task force desired any discussion or clarification of the report, he should be contacted. His committee would be happy to attempt to assist in the understanding and usefulness of this report.

Research Project 8. A paper proposing a course of action for minimizing the possibility that any comparison system will be presented in a manner that creates misunderstanding rather than enlightenment. The paper is to include consideration of participating and nonparticipating policies. The American Life Insurance Association accepted responsibility for producing such a paper and Richard V. Minck, Actuary, mailed each member of the task force a copy of the report on this project with his letter of October 8, 1974.

Research Project 9. Preparation of a paper on the question of whether a single interest rate is practical or whether comparative information should be promulgated at more than one interest rate for alternate use by buyers in differing circumstances. Consideration will also be given to matters of mortality and persistency. The Society of Actuaries' Committee on Cost Comparison Methods and Related Issues (Special) accepted responsibility for this project and Bartley Munson submitted the report, "Analysis of Life Insurance Cost Comparison Index Methods" to the Chairman with his letter of November 8, 1974. As mentioned in the paragraph on Research Project 2, this report is intended to be responsive to both Research Projects 2 and 9.

Research Project 10. A research paper to be prepared dealing with the nature of the whole life insurance contract taking into consideration the assumption that it may be separated into protection and savings elements. The objective for this paper is to provide the consumer with an accurate understanding of what he is purchasing. The Institute of Life Insurance agreed to prepare such a paper and copies of the report, "The Nature of the Whole Life Contract," was furnished to the chairman on August 14, 1974. Copies were forwarded to the other members of the task force with the chairman's letter of October 9.

Research Project 11. A market research project to be undertaken to determine the present state of consumer knowledge of life insurance and the types and level of information that would be viewed by consumers as helpful or needed in the buying decision or process. The Institute of Life Insurance accepted responsibility for this project. In cooperation with the Life Insurance Agency Management Association (now LIMRA), the Institute of Life Insurance prepared a research report dealing with consumer knowledge of life insurance expectations at the point of sale. This was delivered to the chairman December 26, 1973, and copies were mailed to the other members of the task force on January 11, 1974.

The second phase of this project consisted of a detailed exploratory consumer research study about the types and level of comparative information that consumers want and need at the time of purchase particularly with regard to cost comparison information. Preliminary reports on this phase of the project were furnished to the task force at the June 1974 meeting. Printed copies of the publication, "Life Insurance Consumers: An Exploratory Study of Attitudes and Expectations Regarding Cost Comparisons," were furnished to the chairman on June 19, 1974, and forwarded to the other members of the Task Force on October 9, 1974.

William B. Kingsley, Vice President of the Institute of Life Insurance, wrote the Chairman November 22, 1974, that the report on the national survey phase of the overall project was expected to be available prior to the December 1974 NAIC Meeting but has not been completed as yet. The field work has been completed and tabulated and analysis has begun by the LIMRA staff. The final report on this project will be delivered early in 1975.

Research Project 12. Preparation of a mathematical analysis of prevailing cost and value patterns of representative life insurance policies to determine if standards may be envolved to be used to curb "manipulation" of policy values. E. J. Moorhead was asked to prepare this analysis and to furnish examples illustrating different situations that arise. Mr. Moorhead presented a draft of his paper on this project to the Chairman August 23 and asked for comments. Several suggestions were mailed to Mr. Moorhead early in October. Mr. Moorhead advised the Chairman November 26, that he would furnish a final copy of the report in December, 1974.

The Chairman then invited general discussion concerning the manner in which the Task Force should arrange the form of distribution of the complete reports and the manner in which the reports should be studied and discussed by both insurance regulators and the insurance industry. It was indicated that relatively few people in attendance had seen the research reports previously completed.

There being no further matters to be discussed, the meeting was resolved into executive session.

In executive session the task force determined:

1. To receive the research reports previously submitted with an expression of appreciation to those persons responsible for the work.

2. It is the request of the task force that the NAIC Central Office arrange to procure and distribute to each Commissioner one copy of each of the research reports. It is requested that those reports available by January 1 should be mailed to the Commissioners by January 15 and those received subsequent to the first mailing should be furnished to the Commissioners by March 1 if possible.

3. The task force intends to have a meeting in executive session at the time and place of the Spring meeting of the Blanks (A1) Subcommittee.

4. It is the intention of the task force to arrange for a two-day seminar-discussion of all the research project reports at the Zone 5 meeting in April 1975. This session will be open to all interested persons. The general format of this session will be announced by the task force after its executive session mentioned above.

With no further business to come before the task force, the meeting was adjourned.

Hon. Stanley C. DuRose, Chairman, Wisconsin; Hon. William H. Huff III, Iowa; Hon. Dick L. Rottman, Nevada; Hon Don B. Odum, Texas; Hon. Samuel H. Weese, West Virginia.

Some Problems With Special Endowment Policies: A Report

Although this agenda item is shown as "discussion on annual pure endowment contracts," this discussion will center on a form of policy which has most of the characteristics, both good and bad, of the annual pure endowment (APE) contract (did anyone ever call one a policy?) which have plagued regulators for many years. Like the APE policy, these new side-fund policies can serve a very useful purpose when sold for that purpose, but also like the APE the side fund can be sold as a "couponless coupon" policy, with an added factor related to the current levels of interest available to talk about.

In researching this problem, we located eleven examples of such policies in our files. Three were basically annuities, one contained a built-in ten-year term benefit, two were double-protection-to-60, while the remainder were double-protection-to-65. All but one, which was definitely stated to be intended exclusively for HR 10 plans, provided for a first year's premium from 1.5 to 3 times the premium due in second and subsequent years. All provided for a side fund subject to the following guaranteed interest rates: 7½% for 1 year, 5% for the next 5 then 3½% (one form) or 5% (another form); 5% for 10 years, then 4% (six forms); 5% for 10 years, then 3% (three forms).

Guaranteed rate	Quoted rate	1973 earnings (Exhibit 2)
7½/5/4/3½	7½%	5.35%
5/3	9%	7.19%
5/3	7.1%	6.29%

In none of these three companies and in only one of the other seven did the interrogations pertaining to use of the investment-year method of allocation of investment earnings indicate that such a method was in use. In all other instances, however, the company's investment earnings as shown in Exhibit 2 were at least adequate to meet the highest guaranteed rate.

The classic case of misuse, which called the problem to our attention, had to do with a disclosure form given a policyholder or applicant and sent to us in what appeared to be horror by an agent of another company. On this form the insured was a girl, age five. Deposits were illustrated as accumulated at 9% – for sixty years. The company does not earn 9% and has no investments with sixty-year maturities.

These are the questions:

(1) Are such guarantees and payment of excess sums (we have reason to believe that at least 7% is quoted by all) equitable to other policyholders?

(2) Does use of the investment-year method make a difference in the previous answer?

(3) Is the use of a high first premium an example of the abuses of the standard non-forfeiture laws mentioned in the meetings of the task force studying these laws?

(4) At what stage do projections become misrepresentations?

W. Keith Sloan, Life Actuary
Arkansas Insurance Department

VARIABLE LIFE INSURANCE AND VARIABLE ANNUITIES (C4) SUBCOMMITTEE

Reference:
1974 Proc. Vol. I p. 460
1974 Proc. Vol. II p. 537

Hon. James M. Jackson, Chairman - Nebraska
Hon. Gleeson L. Payne, Vice-Chairman - California

AGENDA

1. Receive minutes of Subcommittee meeting in Des Moines, Iowa, September 10, 1974.
2. Receive minutes of Subcommittee meeting in Portland, Maine, October 2, 1974.
3. Current status of the SEC in the regulatory field for variable life insurance.
4. Consideration of adoption of any changes in the model regulation.
5. Consideration of adoption of revised variable contracts regulation.
6. Consideration of adoption of historical notes and drafting comments relating to the model life insurance regulation.
7. Any other matters brought before the Subcommittee.

The Variable Life Insurance (C4) Subcommittee was called to order in the Oaxaca Room of the Camino Real Hotel in Mexico City on Tuesday, December 3, 1974, at 9:00 a.m. Commissioner Jackson presided and a quorum was present.

The Subcommittee received and adopted the minutes of its meetings in Des Moines, (September 10, 1974) and in Portland, Maine (October 2, 1974) (attached).

The subcommittee heard a report from Paul Mason of the ALIA concerning the current status of SEC activity in the variable life insurance regulatory field.

The subcommittee heard comments on proposed revisions of the Model Variable Contracts Regulation. The revisions were proposed in order to exclude variable life insurance from the Variable Contracts Regulation since it is specifically covered in the Variable Life Insurance Regulation.

The subcommittee then heard comments concerning proposed technical amendments to the Model Variable Life Insurance Regulation. Some of these were proposed by Chairman Jackson and additional proposed amendments were offered by the American Life Insurance Association and supported by the industry advisory committee.

The subcommittee then heard comments concerning the proposed adoption of historical notes and drafting comments relating to the Model variable life insurance regulations.

The industry advisory committee, the ALIA, and several other individual industry members, suggested that the notes and commentaries be further studied and that the subcommittee defer any action on them pending more detailed study.

The subcommittee then adjourned and reconvened in executive session.

In executive session the subcommittee took the following action:

1. After considerable discussion the subcommittee adopted the proposed revisions to the Model Variable Contract Regulation as proposed by the (C3) Subcommittee's task force appointed to make recommendations. The revisions make the Model Variable Contract Regulation applicable only to variable annuities. The subcommittee renamed this regulation the "Model Variable Annuity Regulation." The regulation as adopted is attached.

2. After lengthy deliveragion, the subcommittee adopted several technical amendments and amendatory notes to the Model Variable Life Insurance Regulation. The regulation as amended is attached. The subcommittee recognized potential problems in former Article IV Section 3g (as amended, 3f). Therefore, the chairman directed the actuarial members of the subcommittee to study the ALIA amendments proposed to remedy this situation and to make further suggestions so that the subcommittee will be in a position to act accordingly.

3. With respect to the historical notes and drafting comments, the subcommittee, after considerable discussion, determined to refer to them in the future as a "Commentary to the Model Variable Life Insurance Regulation." They further determined to adopt the Commentary subject to suggested revisions, if any, which may be appropriate upon further study. The Commentary as adopted is attached.

4. Superintendent Wallach requested the chairman to secure from the ALIA actuarial staff an updated analysis of the required reserves underlying the guaranteed portion of the minimum death benefit. This requirement was adopted on an interim basis by the NAIC at its December 1972 Regular Meeting in Atlanta.

There being no further business to come before the subcommittee, the meeting was adjourned.

Hon. James M. Jackson, Chairman, Nebraska; Hon Gleeson L. Payne, Vice-Chairman, California; Hon. Ark Monroe III, Arkansas; Hon Thomas C. White, Connecticut; Hon. Maximilian Wallach, D. C.; Hon Joaquin G. Blaz, Guam; Hon. Harold B. McGuffey, Kentucky; Hon. Daniel J. Demlow, Michigan; Hon. Berton W. Heaton, Minnesota; Hon. Benjamin R. Schenk, New York; Hon. Lester L. Rawls, Oregon.

Variable Life Insurance and
Variable Annuities (C4) Subcommittee
Des Moines, Iowa
September 10, 1974

The Variable Life Insurance and Variable Annuities (C4) Subcommittee met at the Airport Terminal in Des Moines, Iowa, on September 10, 1974 at 2:00 p.m.

The subcommittee received for consideration the ALIA-proposed technical suggestions for amending the VLI Model Regulation. The chairman made it clear that it certainly was not his intention, and that he was not aware of any intention within the (C4) Subcommittee, to consider any substantive changes to the model regulation. Rather it was his understanding that the ALIA proposals were attempts to more clearly state the intentions underlying various provisions of the Model Variable Life Insurance Regulation.

Larry Gilbertson, chairman of the industry advisory committee, reported that his committee was not in favor of any substantive changes in the regulation.

James Baylor of NARe Life Services Company remarked that any technical changes should be reviewed in light of and in conjunction with the drafting comments which were being prepared by the subcommittee.

Jule Stocker, representing the Equitable Life Assurance Society of the United States, remarked that the NAIC's latest response to the Securities and Exchange Commission stated that changes in the model regulation should be the result of regulatory experience and that such experience did not yet exist. Therefore, he stated that there should be no substantive changes in the model regulation until such experience has unfolded.

The subcommittee then addressed the problem of cost disclosure and cost comparison for variable life insurance. The chairman announced the creation of a task force consisting of Bob Lomicky and Jerry Dolman of the New York Department and Keith Sloan of the Arkansas Department to work in conjunction with the (C3) Life Insurance Cost Comparison Task Force. A representative of the Wisconsin Department noted on behalf of Commissioner DuRose that the work of the (C3) Task Force would be a lengthy project.

The subcommittee next addressed the question of the monitoring of variable life insurance operations pursuant to the Executive Committee resolution of May 4, 1974. It was agreed that for the time being recommendations should be made for using the variable life insurance blank to obtain information which would be desirable in this regard. The chairman announced that he was appointing a task force to make suggestions to the Blanks Subcommittee concerning the variable life insurance blank. It would properly be a function of this task force to address the problem for the time being.

The chairman then announced that he had appointed Pete Kelly of the Connecticut Department and Bob Rowe of the Michigan Department as a task force to make suggestions to the Blanks Subcommittee concerning the proposed variable life insurance blank.

The subcommittee then heard a report on the status of drafting comments being prepared by the NAIC Central Office staff.

The subcommittee then discussed the desirability of conducting seminars for state insurance departments on the workings of variable life insurance and the Model Variable Life Insurance Regulation. There was a general consensus that such seminars would be a good idea, and Chairman Jackson announced his intention to inquire among the various states as to whether or not they would be interested in attending such a seminar. It was suggested that the spring zone meetings would present an opportunity for such workshops.

The chairman announced the creation of a task force consisting of himself and Don Erway of the Nebraska Department to propose amendments to the Model Variable Contracts Regulation so that it be applicable to variable life insurance.

There being no further business, the subcommittee adjourned.

Hon. James M. Jackson, Chairman, Nebraska; Hon. Gleeson L. Payne, Vice-Chairman, California; Hon. Ark Monroe III, Arkansas; Hon Thomas C. White, Connecticut; Hon. Maximilian Wallach, D. C.; Hon. Joaquin G. Blaz, Guam; Hon. Harold B. McGuffey, Kentucky; Hon. Daniel J. Demlow, Michigan; Hon. Berton W. Heaton, Minnesota; Hon. Benjamin R. Schenck, New York; Hon. Lester L. Rawls, Oregon.

Variable Life Insurance and
Variable Annuities (C4) Subcommittee
Portland, Maine
October 2, 1974

The Variable Life Insurance and Variable Annuities (C4) Subcommittee met at the Downtown Holiday Inn in Portland, Maine on October 2, 1974 at 9:00 a.m.

The subcommittee heard reports on the status of task force projects assigned by the chairman at the Des Moines meeting.

A report was given by Larry Gilbertson, chairman of the industry advisory committee, concerning a survey he had taken on state activity thus far with respect to the model VLI regulation.

The subcommittee went through a line-by-line examination of the ALIA technical proposals received at the Des Moines meeting and heard comments from interested persons.

There being no further business, the subcommittee adjourned.

Hon. James M. Jackson, Chairman, Nebraska; Hon. Gleeson L. Payne, Vice-Chairman, California; Hon. Ark Monroe, III, Arkansas; Hon. Thomas C. White, Connecticut; Hon. Maximilian Wallach, D. C.; Hon. Joaquin G. Blaz, Guam; Hon. Harold B. McGuffey, Kentucky; Hon. Daniel J. Demlow, Michigan; Hon. Berton W. Heaton, Minnesota; Hon. Benjamin R. Schenck, New York; Hon. Lester L. Rawls, Oregon.

MODEL VARIABLE ANNUITY REGULATION

(As Adopted December 3, 1974)

ARTICLE I: AUTHORITY

Pursuant to authority given by Section ____ of the Insurance Laws of ______ , the Insurance _______, after due notice and publication and after affording interested persons opportunity to present written data, views and arguments, does hereby make and promulgate the following rules and regulations to be applicable to insurance companies delivering or issuing for delivery in this state variable annuities, as defined in Paragraph 1 of Article II, pursuant to Section ____ of the Insurance Laws of this State.

These regulations shall become effective _______.

NOTE: This Article will obviously depend on the existing provisions under a given state's insurance code with respect to the method for adopting rules and regulations.

ARTICLE II: DEFINITIONS

1. The term "variable annuity" when used in this Regulation, shall mean any policy or contract which provides for annuity benefits which vary according to the investment experience of any separate account or accounts maintained by the insurer as to such policy or contract, as provided for in Section ____ of the laws of this state.

NOTE: The objective here is to define the contracts covered by the regulations to include all forms of annuity contracts the benefits of which vary according to the investment experience of a separate account authorized by the enabling statute, including group and individual, variable accumulation and variable benefit, etc. Exclusion of particular kinds of contracts from sections of the regulation which may be inapplicable is handled in those sections.

2. "Agent," when used in the Regulation, shall mean any person, corporation, partnership, or other legal entity which under the laws of this State is licensed as a life insurance agent, or solicitor, general agent, or life insurance broker.

NOTE: States should make the necessary changes in terminology to conform with statutory language describing those persons eligible to be licensed to sell life insurance.

ARTICLE III: QUALIFICATION OF INSURANCE COMPANIES TO ISSUE VARIABLE ANNUITIES

1. No company shall deliver or issue for delivery variable annuities within this State unless (a) it is licensed or organized to do a life insurance or annuity business in this State, and (b) the Commissioner is satisfied that its condition or method of operation in connection with the issuance of such contracts will not render its operation hazardous to the public or its policyholders in this State. In this connection, the Commissioner shall consider among other things:

(i) The history and financial condition of the company;

(ii) The character, responsibility and fitness of the officers and directors of the company; and

(iii) The law and regulation under which the company is authorized in the state of domocile to issue variable annuities.

2. If the company is a subsidiary of an admitted life insurance company, or affiliated with such company by common management or ownership, it may be deemed by the Commissioner to have satisfied the provisions of clause (b) of Paragraph 1 hereof if either it or such admitted life company satisfies the aforementioned provisions; provided, further, that companies licensed and having a satisfactory record of doing business in this State for a period of at least three years may be deemed to have satisfied the Commissioner with respect to clause (b) of Paragraph 1 above.

3. Before any company shall deliver or issue for delivery variable annuities within this State it shall submit to the Commissioner (a) a general description of the kinds of variable annuities it intends to issue, (b) if requested by the Commissioner, a copy of the statutes and regulations of its state of domicile under which it is authorized to issue variable annuities, and (c) if requested by the Commissioner, biographical data with respect to officers and directors of the company on the NAIC uniform biographical data forms.

NOTE: Paragraph 3 suggests the type of submission which might be appropriate to afford a basis for determining that a company meets the test in clause (b) of Paragraph 1. The NAIC biographical data regulation and forms appear in the 1967 Proc. II 382-385 and 1974 Proc. I 120-123

Some state statutes provide seasoning requirements for the licensing of foreign life insurance companies; these statutes presumably will also apply to companies seeking to be licensed to sell variable annuities. The Committee does not believe that there is a need for seasoning requirements for companies writing variable annuities beyond those required for life companies generally. If, however, an additional seasoning requirement for companies writing variable annuities is considered desirable, the Committee feels that such a requirement should be specifically provided by statute and recommends that the statute expressly require consideration of the experience of a parent or affiliated company. See Paragraph 2 above.

The Committee recommends that if there are specific capital and surplus requirements for companies writing variable annuities these should be the same as those for life insurance companies generally. If stricter capital and surplus requirements should be considered necessary, these should be specifically provided by statute and it is strongly recommended that the statute permit waiver of such requirements pursuant to rules and regulations duly adopted by the Commissioner. A regulation to accomplish this purpose might read as follows:

> *The Commissioner may waive any or all the requirements set forth in Section ____ if by reason of a company's capital structure, surplus, amount of business in force and plan of operations, it substantially conforms to such requirements, or, in the opinion of the Commissioner, otherwise affords adequate protection to contract holders.*

ARTICLE IV: SEPARATE ACCOUNT

A domestic company issuing variable annuities shall establish one or more separate accounts pursuant to Section ____ of the Insurance Laws of this State, subject to the following provisions of this Article:

1(a). Except as may be provided with respect to reserves for guaranteed benefits and funds referred to in Paragraph 1(b), (i) amounts allocated to any separate account and accumulations thereon may be invested and reinvested without regard to any requirements or limitations prescribed by the laws of this State governing the investments of life insurance companies and (ii) the investments in such separate account or accounts shall not be taken into account in applying the investment limitations otherwise applicable to the investments of the company.

1(b). Reserves for (i) benefits guaranteed as to dollar amount and duration and (ii) funds guaranteed as to principal amount or stated rate of interest may be maintained in a separate account equal to such reserve liability is invested in accordance with the laws and regulations of this State governing the investments of life insurance companies. Such portion of the assets also shall not be taken into account in applying the investment limitations otherwise applicable to the investments of the company.

1(c). With respect to 75% of the market value of the total assets in a separate account no company shall purchase or otherwise acquire the securities of any issuer, other than securities issued or guaranteed as to principal or interest by the United States, if immediately after such purchase or acquisition the market value of such investment, together with prior investments of such separate account in such security taken at market, would exceed 10% of the market value of the assets of said separate account; provided, however, that the Commissioner may waive such limitation if, in his opinion, such waiver will not render the operation of such separate account hazardous to the public or policyholders in this State.

1(d). Unless otherwise permitted by law or approved by the Commissioner, no company shall purchase or otherwise acquire for its separate accounts the voting securities of any issuer if as a result of such acquisition the insurance company and its separate accounts, in the aggregate, will own more than 10% of the total issued and outstanding voting securities of such issuer; provided, that the foregoing shall not apply with respect to securities held in separate accounts, the voting rights in which are exercisable only in accordance with instructions from persons having interests in such accounts.

1(e). The limitations provided in Paragraphs 1(c) and 1(d) above shall not apply to the investment with respect to a separate account in the securities of an investment company registered under the Investment Company Act of 1940, provided that the investments of such investment company comply in substance with Paragraphs 1(c) and 1(d) hereof.

NOTE: Virtually all statutes contain the broad language in Paragraph 1(a) permitting investments without regard to investment limitations with respect to life insurance companies. Paragraph 1(c) would impose a quantitative limitation to promote diversification and limit investment risk. It should be noted that while separate accounts registered under the 1940 Act will be subject to the 5% rule under that Act, there would appear to be sound reasons for permitting greater flexibility, up to 10%, with respect to those separate accounts not so subject. It is further provided that the Commissioner may waive this limitation where such would not render the operation of the account hazardous.

Paragraph 1(d) would prohibit the acquisition by the separate account of the securities of an issuer if the acquisition would result in the ownership of more than 10% of the voting securities of such issuer, with the holdings by the company and all of its separate accounts aggregated, except when there is a pass-through of voting rights to contractholders.

Paragraph 1(f) is intended primarily to permit the operation of a separate account as a unit investment trust under the 1940 Act, with all of its assets being invested in the securities of a registered investment company. It should be noted, however, that the Commissioner would retain indirect control since the exception from the application of Paragraphs 1(c) and 1(d) would not apply if the investments of the investment company did not comply with such Paragraphs.

Basic authority for exemption from investment limitations, as well as the quantitative limitations in Paragraphs 1(c) and 1(d) and the exemption from these limitations in Paragraph 1(f), should probably be covered by statute.

2. Unless otherwise approved by the Commissioner, assets allocated to a separate account shall be valued at their market value on the date of valuation, or if there is no readily available market, then as provided under the terms of the contract or the rules or other written agreement applicable to such separate account; provided, that unless otherwise approved by the Commisioner, the portion, if any, of the assets of such separate account equal to the company's reserve liability with regard to the benefits and funds referred to in clauses (i) and (ii) of Paragraph 1(b) shall be valued in accordance with the rules otherwise applicable to the company's assets.

NOTE: In the case of variably annuities involving a 1940 Act registered account and in many group contracts the procedure for valuing assets will be stated in rules of the separate accounts or in a separate applicable written agreement, and the regulation is drafted to permit this.

3. If and to the extent so provided under the applicable contracts, that portion of the assets of any such separate account equal to the reserves and other contract liabilities with respect to such account shall not be chargeable with liabilities arising out of any other business the company may conduct.

NOTE: To achieve effective insulation of certain assets held in separate accounts from claims of general creditors it is probably necessary, as a matter of general corporate law, that such insulation be specifically authorized by statute.

4. Notwithstanding any other provisions of law a company may

(a) with respect to any separate account registered with the Securities and Exchange Commission, as a unit investment trust exercise voting rights in connection with any securities of a regulated investment company registered under the Investment Company Act of 1940 and held in such separate accounts in accordance with instructions from persons having interests in such accounts ratably as determined by the company, or

(b) with respect to any separate account registered with the Securities Exchange Commission as a management investment company, establish for such account a committee, board, or other body, the members of which may or may not be otherwise affiliated with such company and may be elected to such membership by the vote of persons having interests in such account ratably as determined by the company. Such committee, board or other body may have the power, exercisable alone or in conjunction with others to manage such separate account and the investment of its assets.

A company, committee, board or other body may make such other provisions in respect to any such separate account as may be deemed appropriate to facilitate compliance with requirements of any federal or state law now or hereafter in effect; provided that the Commissioner approves such provisions as not hazardous to the public or the company's policyholders in this state.

NOTE: Certain separate accounts are registered with the Securities and Exchange Commission under the Investment Company Act of 1940, and contractholders in such separate accounts must be given voting rights, principally in connection with the management of the assets of the account. Subparagraph 4(a) is intended to provide for a separate account registered with the SEC as a unit investment trust, under which all of the assets of the account are invested in a separate mutual fund. In this connection, see also Paragraph 1(f). Subparagraph 4(a) would permit a pass-through of voting rights in the shares of the underlying mutual fund to the contractholders.

Where a separate account is registered under the 1940 Act as a management investment company the contractholders have the right to elect a committee with power to manage the account and invest its assets. Subparagraph 4(b).

As with the insulation provision in Paragraph 3 of Article IV above, it would probably be wise in most states to provide authority for the above regulation by statute, since many states require that the assets of an insurer may be managed by its board of directors.

5. No sale, exchange or other transfer of assets may be made by a company between any of its separate accounts or between any other investment account and one or more of its separate accounts unless, in case of a transfer into a separate account, such transfer is made solely to establish the account or to support the operation of the contracts with respect to the separate account to which the transfer is made, and unless such transfer, whether into or from a separate account, is made (a) by a transfer of cash, or (b) by a transfer of securities having a valuation which could be readily determined in the marketplace, provided that such transfer of securities is approved by the Commissioner. The Commissioner may authorize other transfers among such accounts, if, in his opinion, such transfers would not be inequitable.

NOTE: This provision, common to many existing statutes and regulations, is intended to prevent unfair or discriminatory transfer among accounts. Regular cash flow should permit those transfers to and from the general account necessary to the operation of the variable annuity business to be made in cash.

6. The company shall maintain in each such separate account assets with a value at least equal to the reserves and other contract liabilities with respect to such account, except as may otherwise be approved by the Commissioner.

NOTE: This section varies from a number of existing regulations which provide that assets shall be equal to reserves. The Committee agrees that a deficit should not be permitted, but that build-up of surplus within the separate account should not be prohibited as it would apparently be under the existing regulations referred to.

7. Rules under any provision of the Insurance Laws of this State or any regulation applicable to the officers and directors of insurance companies with respect to conflicts of interest shall also apply to members of any separate account's committee, board or other similar body. No officer or director of such company nor any member of the committee, board or body of a separate account shall receive directly or indirectly any commission or any other compensation with respect to the purchase or sale of assets of such separate account.

ARTICLE V: FILING OF CONTRACTS

The filing requirements applicable to variable annuities shall be those filing requirements otherwise applicable under existing statutes and regulations of this State with respect to individual and group life insurance and annuity contract form filings, to the extent appropriate.

ARTICLE VI: VARIABLE ANNUITY CONTRACTS

1. Any variable annuity providing benefits payable in variable amounts delivered or issued for delivery in this State shall contain a statement of the essential features of the procedures to be followed by the insurance company in determing the dollar amount of such variable benefits. Any such contract, including a group contract and any certificate in evidence of variable benefits issued thereunder, shall state that such dollar amount will vary to reflect investment experience and shall contain on its first page a clear statement to the effect that the benefits thereunder are on a variable basis.

2. Illustrations of benefits payable under any variable annuity shall not include projections of past investment experience into the future or attempted predictions of future investment experience; provided that nothing contained herein is intended to prohibit use of hypothetical sssumed rates of return to illustrate possible levels of benefits.

3. No individual variable annuity contract calling for the payment of periodic stipulated payments shall be delivered or issued for delivery in this State unless it contains in substance the following provisions or provisions which in the opinion of the Commissioner are more favorable to the holders of such contracts:

(a) A provision that there shall be a period of grace of 30 days or of one month, within which any stipulated payment to the insurer falling due after the first may be made, during which period of grace the contract shall continue in force. The contract may include a statement of the basis for determining the date as of which any such payment received during the period of grace shall be applied to produce the values under the contract arising therefrom;

(b) A provision that, at any time within year(s) from the date of default, in making periodic stipulated payments to the insurer during the life of the annuitant and unless the cash surrender value has been paid, the contract may be reinstated upon payment to the insurer of such overdue payments as required by contract, and of all indebtedness to the insurer on the contract, including interest. The contract may include a statement of the basis for determining the date as of which the amount to cover such overdue payments and indebtedness shall be applied to produce the values under the contract arising therefrom;

(c) A provision specifying the options available in the event of default in a periodic stipulated payment. Such options may include an option to surrender the contract for a cash value as determined by the contract, and shall include an option to receive a paid-up annuity if the contract is not surrendered for cash, the amount of such paid-up annuity being determined by applying the value of the contract at the annuity commencement date in accordance with the terms of the contract.

NOTE: The Committee would recommend inclusion of provisions dealing with grace, reinstatement and nonforfeiture only if the law of a particular state requires these in individual fixed dollar deferred annuities. Several companies issuing variable annuity contracts do not require contractholders to make periodic stipulated payments. If a contractholder ceases making payments he may resume doing so thereafter at any time. It is assumed that Paragraph 3(a) would be inapplicable to such contracts since the provisions described above would be regarded as more favorable to the contractholders than a 30 day grace period.

4. Any variable annuity contract delivered or issued for delivery in this State shall stipulate the investment increment factors to be used in computing the dollar amount of variable benefits or other variable contractual payments or values thereunder, and may guarantee that expense and/or mortality results shall not adversely affect such dollar amounts. In the case of an individual variable annuity contract under which the expense and mortality results may adversely affect the dollar amount of benefits, the expense and mortality factors shall be stipulated in the contract.

In computing the dollar amount of variable benefits or other contractual payments or values under an individual variable annuity contract:

(a) The annual net investment increment assumption shall not exceed 5% except with the approval of the Commissioner;

(b) To the extent that the level of benefits may be affected by future mortality results, the mortality factor shall be determined from the Annuity Mortality Table for 1949, Ultimate, or any modification of that table not having a lower life expectancy at any age, or, if approved by the Commissioner, from another table.

"Expense" as used in this Paragraph, may exclude some or all taxes, as stipulated in the contract.

5. The reserve liability for variable annuities shall be established pursuant to the requirements of the Standard Valuation Law in accordance with actuarial procedures that recognize the variable nature of the benefits provided and any mortality guarantees.

ARTICLE VII: REQUIRED REPORTS

1. Any company issuing individual variable annuities shall mail to the contractholder at least once in each contract year after the first at his last address known to the company, a statement or statements reporting the investments held in the separate account. The company shall submit annually to the Insurance Commissioner a statement of business of its separate account or accounts in such form as may be prescribed by the National Association of Insurance Commissioners.

NOTE: The Committee intended to leave this language sufficiently flexible to apply in the event that the separate account statement is combined with the regular life blank.

2. Any company issuing individual variable annuities shall mail to the contractholder at least once in each contract year after the first at his last address known to the company, a statement reporting as of a date not more than four months previous to the date of mailing. In the case of an annuity contract under which payments have not yet commenced, (a) the number of accumulation units credited to such contract and the dollar value of a unit, or (b) the value of the contractholder's account.

ARTICLE VIII: FOREIGN COMPANIES

If the law or regulation in the place of domocile of a foreign company provides a degree of protection to the policyholders and the public which is substantially equal to that provided by these regulations, the Commissioner, to the extent deemed appropriate by him in his discretion, may consider compliance with such law or regulation as compliance with these regulations.

NOTE: This blanket provision would permit a Commissioner to waive any or all of those requirements applicable to foreign companies in cases where the quality of regulation in the state of domicile is such that he would have every reason to expect that the company would be adequately regulated.

ARTICLE IX: QUALIFICATION OF AGENTS FOR THE SALE OF VARIABLE ANNUITIES

1(a). No person may sell or offer for sale in this state any variable annuity contract unless such person is an agent and has filed with the Commissioner, in a form satisfactory to the Commissioner, evidence that such person holds any license or authorization which may be required for the solicitation or sale of variable annuity contracts by any federal or state securities law.

1(b). Any examination administered by the Department for the purpose of determining the eligibility of any person for licensing as an agent shall, after the effective date of this regulation, include such questions concerning the history, purpose, regulation, and sale of variable annuity contracts as the Commissioner deems appropriate.

2. Any person qualified in this state under this Article to sell or offer to sell variable annuity contracts shall immediately report to the Commissioner.

2(a). any suspension or revocation of his agent's license in any other state or territory of the United States;

2(b). the imposition of any disciplinary sanction, including suspension or expulsion from membership, suspension, or revocation of or denial of registration, imposed upon him by any national securities exchange, or national securities association, or any federal, state, or territorial agency with jurisdiction over securities or variable annuity contracts;

2(c). any judgement or injunction entered against him on the basis of conduct deemed to have involved fraud, deceit, misrepresentation, or violation of any insurance or securities law or regulation.

3. The Commissioner may reject any application or suspend or revoke or refuse to renew any agent's qualification under this Article to sell or offer to sell variable annuity contracts upon any ground that would bar such applicant or such agent from being licensed to sell other life insurance contracts in this state. The rules governing any proceeding relating to the suspension or revocation of an agent's license shall also govern any proceeding for suspension or revocation of an agent's qualification to sell or offer to sell variable annuity contracts.

MODEL VARIABLE LIFE INSURANCE REGULATION WITH TECHNICAL AMENDMENTS

(Amended Regulation as Adopted
3 Dec. 1974 by the NAIC)

[Deletions] New Material

ARTICLE I: AUTHORITY

The following regulations applicable to variable life insurance policies are promulgated under the authority of Section ____, of the Insurance Laws of ____, and are effective ____

ARTICLE II: DEFINITIONS

As used in this regulation:

1. "Affiliate" of an insurer means any person, directly or indirectly, controlling, controlled by, or under common control with such insurer; any person who regularly furnishes investment advice to such insurer with respect to its variable life insurance separate accounts for which a specific fee or commission is charged; or any director, officer, partner, or employee of any such insurer, controlling or controlled person, or person providing investment advice or any member of the immediate family of such person.

2. "Agent" means any person, corporation, partnership, or other legal entity which is licensed by this state as a life insurance agent.[3]

3. "Assumed investment rate" means the rate of investment return which would be required to be credited to a variable life insurance policy, after deduction of charges for taxes, investment expenses and mortality and expense guarantees to maintain the variable death benefit equal at all times to the amount of death benefit, other than incidental insurance benefits, which would be payable under the plan of insurance if the death benefit did not vary according to the investment experience of the separate account.

4. "Benefit base" means the amount, not less than the amount specified under Sec. 2b of Article VI, specified by the terms of the variable life insurance policy to which the difference between the net investment return and the assumed investment rate is applied in determining the variable benefits of the policy.

5. "Commissioner" (Director, Superintendent) means the Insurance Commissioner (Director, Superintendent) of this state.[4]

6. "Control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or non-management services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing more than ten (10) percent of the voting securities of any other person. This presumption may be rebutted by a showing made to the satisfaction of the Commissioner that control does not exist in fact. The Commissioner may determine, after furnishing all persons in interest notice and opportunity to be heard and making specific findings of fact to support such determination, that control exists in fact, notwithstanding the absence of a presumption to that effect.

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1. DRAFTING NOTE: The blank portions of this article should be completed with appropriate references to the section of the Variable Contract Law authorizing promulgation of regulations and to appropriate additional citations such as the general rule-making authority of the Commissioner.

2. DRAFTING NOTE: Each definition should be reviewed to assure that the definition corresponds to the actual language used by the statutes of the particular state. Additional definitions may be necessary.

3. DRAFTING NOTE: Those states which have life insurance brokers and/or solicitors should modify the definition of agent to include them.

4. DRAFTING NOTE: Each state should modify the term "Commissioner" so that it corresponds to the correct title of the insurance regulatory official in the state where this regulation is adopted.

7. "General account" means all assets of the insurer other than assets in separate accounts established pursuant to Section __ of the Insurance Laws of this state, or pursuant to the corresponding section of the Insurance Laws of the state of domicile of a foreign or alien insurer, whether or not for variable life insurance.

8. "Incidental insurance benefit" means all insurance benefits in a variable life insurance policy, other than the variable death benefit and the minimum death benefit, including but not limited to accidental death and dismemberment benefits, disability income benefits, guaranteed insurability options, family income, or fixed benefit term riders.

9. "May" is permissive.

10. "Minimum death benefit" means the amount of the guaranteed death benefit, other than incidental insurance benefits, payable under a variable life insurance policy regardless of the investment performance of the separate account.

11. "Net investment return" means the rate of investment return in a separate account to be applied to the benefit base [actually credited to a variable life insurance policy,] after deduction of charges for taxes, investment expenses and mortality and expense guarantees in accordance with the terms of the policy.

12. "Person" means an individual, corporation, partnership, association, trust, or fund.

13. "Separate account" means a separate account established [under] for variable life insurance pursuant to Section __ of the Insurance Laws of this state or pursuant to the corresponding Section of the Insurance Laws of the state of domicile of a foreign or alien insurer. [for variable life insurance.]

14. "Shall" is mandatory.

15. "Variable death benefit" means the amount of the death benefit, other than incidental insurance benefits, payable under a variable life insurance policy dependent on the investment performance of the separate account, which the insurer would have to pay in the absence of the minimum death benefit.

16. "Variable life insurance policy" means any individual policy which provides for life insurance which varies according to the investment experience of any separate account or accounts established and maintained by the insurer as to such policy, [as provided for in] pursuant to Section __ of the Insurance Laws of this state or pursuant to the corresponding section of the Insurance Laws of the state of domicile of a foreign or alien insurer.

ARTICLE III: QUALIFICATION OF INSURER TO ISSUE VARIABLE LIFE INSURANCE

The following requirements are applicable to all insurers either seeking authority to issue variable life insurance in this state or which have authority to issue variable life insurance in this state.

1. Licensing and Approval to Do Business in This State: An insurer shall not deliver or issue for delivery in this state any variable life insurance policy unless:

   a. the insurer is licensed or organized to do a life insurance business in this state;

   b. the state of domicile of such insurer requires that permissible investments be substantially the same as provided in Section 3 of Article VI and that changes in the investment policy of the variable life insurance separate account be regulated in a manner substantially similar to that required under Article VI for such separate accounts operated by insurers domiciled in this state; and

   the insurer has obtained the written approval of the Commissioner for the issuance of variable life insurance policies in this state. The Commissioner shall grant such written approval only after he has found that:

   (1) the plan of operation for the issuance of variable life insurance policies is not unsound;

   (2) the general character, reputation, and experience of the management and those persons or firms proposed to supply consulting, investment, administrative, or custodial services to the insurer are such as to reasonably assure competent operation of the variable life insurance business of the insurer in this state; and

(3) the present and foreseeable future financial condition of the insurer and its method of operation in connection with the issuance of such policies is not likely to render its operation hazardous to the public or its policyholders in this state. The Commissioner shall consider, among other things:

(A) the history of operation and financial condition of the insurer;

(B) the qualifications, fitness, character, responsibility, reputation, and experience of the officers and directors and other management of the insurer and those persons or firms proposed to supply consulting, investment, administrative, or custodial services to the insurer;

(C) the applicable law and regulations under which the insurer is authorized in its state of domicile to issue variable life insurance policies. The state of entry of an alien insurer shall be deemed its state of domicile for this purpose; and

(D) if the insurer is a subsidiary of, or is affiliated by common management or ownership with another company, its relationship to such other company and the degree to which the requesting insurer, as well as the other company, meet these standards.

2. Filing for Approval to Do Business in This State: Before any insurer shall deliver or issue for delivery any variable life insurance policy in this state, it must file with this Department the following information for the consideration of the Commissioner in making the determination required by Section 1, subsection c of this Article:

a. copies of and a general description of the variable life insurance policies it intends to issue;

b. a general description of the methods of operation of the variable life insurance business of the insurer, including the names of those persons or firms proposed to supply consulting, investment, administrative, or custodial services to the insurer;

c. with respect to any separate account maintained by an insurer for any variable life insurance policy, a statement of the investment policy the [company] insurer intends to follow for the investment of the assets held in such separate account. The statement shall include a description of the investment objective and orientation intended for the separate account:

d. a description of any investment advisory services contemplated as required by Section 10 of Article VI;

e. if requested by the Commissioner, a copy of the statutes and regulations of the state of domicile of the insurer under which it is authorized to issue variable life insurance policies; and

f. if requested by the Commissioner, biographical data with respect to officers and directors of the insurer on the National Association of Insurance Commissioners Uniform Biographical Data Form.

3. Standards of Suitability. Every insurer seeking approval to enter into the variable life insurance business in this state shall adopt by formal action of its Board of Directors and file with the Commissioner a written statement specifying the Standards of Suitability to be used by the insurer and applicable to its officers, directors, employees, affiliates, and agents with respect to the suitability of variable life insurance for the applicant. Such Standards of Suitability shall be binding on the insurer[,] and those to whom it refers, and shall specify[: a.] that no recommendations shall be made to an applicant to purchase a variable life insurance policy and that no variable life insurance policy shall be issued in the absence of reasonable grounds to believe that the purchase of such policy is not unsuitable for such applicant on the basis of information furnished after reasonable inquiry of such applicant concerning the applicant's insurance and investment objectives, financial situation and needs, and any other information known to the insurer or to the agent making the recommendation. [b.] Lapse rates for variable life insurance within the first two policy years which are significantly higher than both those encountered by the insurer or an affiliate thereof for corresponding fixed benefit life insurance policies and lapse rates of other insurers issuing variable life insurance policies shall be considered by the Commissioner in determining whether the guidelines adopted by the insurer are reasonable and also whether the insurer and its agents are engaging, as a

general business practice, in the sale of variable life insurance to persons for whom it is unsuitable. For purposes of this [sub] section, conversions from variable life insurance to fixed benefit life insurance policies pursuant to this regulation shall not be considered lapses.

4. Use of Sales Materials: An insurer authorized to transact variable life insurance business in this state shall not use any sales material, advertising material, or descriptive literature or other materials of any kind in connection with its variable life insurance business in this state which is false, misleading, deceptive, or inaccurate.[5]

   a. All variable life insurance sales material, advertising material, and descriptive literature shall be filed (____ business days prior to use)[6](within ___ business days after use)[7] with the Commissioner who shall require an insurer to cease the use of any such materials upon finding that any such materials are false, misleading, deceptive, or inaccurate. Revised versions of such materials containing changes of substantial import from versions on file with the Commissioner shall be filed with the Commissioner.

   b. For purposes of this regulation, variable life insurance sales material, advertising material, or descriptive literature shall include but is not limited to:

      (1) printed and published material, audio-visual material, and descriptive literature of an insurer used in direct mail, newspapers, magazines, radio scripts, TV and film scripts, billboards, and similar displays for variable life insurance;

      (2) descriptive literature and sales aids of all kinds used to sell variable life insurance by or on behalf of an insurer or any person authorized to sell variable life insurance for presentation to members of the insurance-buying public, including but not limited to circulars, leaflets, booklets, depictions, illustrations, and form letters; and

      (3) prepared sales talks, presentations, and material for use in the sale of variable life insurance by any person authorized to sell variable life insurance.

5. Requirements Applicable to Contractual Services

   a. Any contract between an insurer and suppliers of consulting, investment, administrative, sales, marketing, custodial, or other services which are material with respect to variable life insurance operations shall be in writing and provide that the supplier of such services shall furnish the Commissioner with any information or reports in connection with such services which the Commissioner may request in order to ascertain whether the variable life insurance operations of the insurer are being conducted in a manner consistent with these regulations and any other applicable law or regulations.

   b. Such contract shall be fair and equitable to all parties and not endanger any policyholders of the insurer in this state.

   c. Such contract shall not relieve the insurer from any responsibilities or obligations imposed upon the operations of its variable life insurance business by this regulation or any other law or regulation.

6. Reports to the Commissioner: Any insurer authorized to transact the business of variable life insurance in this state shall submit to the Commissioner, in addition to any other materials which may be required by this regulation or any other applicable laws or regulations:

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5. DRAFTING NOTE: Those states which do not wish to have sales material filed may make appropriate amendments to this Section.

6. DRAFTING NOTE: Those states which desire filing prior to use should include this provision and insert the desired number of days.

7. DRAFTING NOTE: Those states which desire use and file should use this provision and insert a maximum time period after use for filing.

a. an Annual Statement of the business of its variable life insurance separate account or accounts in such form as may be prescribed by the National Association of Insurance Commissioners; and

b. prior to the use in this state any Information Furnished to Applicants as provided for in Article VII; and

c. prior to the use in this state the form of any of the Reports to Policyholders as provided for in Article IX; and

d. such additional information concerning its variable life insurance operations or its variable life insurance separate accounts as the Commissioner shall deem necessary.

e. Any material submitted to the Commissioner under this Section shall be disapproved if it is found to be false, misleading, deceptive, or inaccurate in any material respect and, if previously distributed, the Commissioner shall require the distribution of an amended report.

7. Authority of Commissioner to Disapprove: Any material required to be filed with the Commissioner, or approved by him, shall be subject to disapproval if at any time it is found by him not to comply with the standards established by this regulation.

ARTICLE IV: INSURANCE POLICY REQUIREMENTS

Policy Qualification The Commissioner shall not approve any variable life insurance form filed pursuant to this regulation unless it conforms to the requirements of this Article.

1. Filing of Variable Life Insurance Policies: All variable life insurance policies, and all riders, endorsements, applications and other [related] documents which are to be attached to and made a part of the policy and which relate to the variable nature of the policy, shall be filed with the Commissioner and approved by him in writing prior to delivery or issuance for delivery in this state.

   a. The procedures and requirements for such filing and approval shall be, to the extent appropriate and not inconsistent with this regulation, the same as those otherwise applicable to other life insurance policies.

   b. The Commissioner may approve variable life insurance policies and related forms with provisions the Commissioner deems to be not less favorable to the policyholder and the beneficiary than those required by this regulation.

   c. The requirements of Sections 2a, 2d, 3e(1) and 3[q]p of this Article shall not apply to variable life insurance policies and related forms issued in connection with [corporate] pension, [and] profit-sharing and retirement plans [and retirement income H. R. 10 pension plans which] if separate accounts for such policies are exempt pursuant to Section 3(c)(11) of the Investment Company Act of 1940 [and where applicable other provisions of the Federal securities laws because of their tax qualified status].

2. Mandatory Policy Benefit and Design Requirements: Variable life insurance policies delivered or issued for delivery in this state shall comply with the following minimum requirements:

   a. Coverage shall be provided for the lifetime of the insured with the mortality and expense risk borne by the insurer.

   b. Gross premiums for death benefits shall be a level amount for the duration of the premium payment period, but this subsection shall not be construed to prohibit temporary or permanent additional premiums for incidental insurance benefits or substandard risks. This subsection shall not be deemed to prohibit the use of fixed benefit preliminary term insurance for a period not to exceed 120 days from the date of the application for a variable life insurance policy. The premium rate for such preliminary term insurance shall be stated separately in the application or receipt.

   c. A minimum death benefit [is] shall be provided in an amount at least equal to the initial face amount of the policy so long as premiums are duly paid [when due] (subject to the provisions of Section 4b of this Article);

   d. The amount payable upon the death of the insured so long as premiums are [paid when due] duly paid (subject to the provisions of Section 4b of this Article) shall be not less than a minimum multiple of the gross premium payable in that year, exclusive of that portion allocable to any incidental insurance benefit, by a person who meets standard underwriting requirements, as shown in the following table:

ISSUE AGES	MULTIPLES
0 - 5	80
6 - 10	71
11 - 15	63
16 - 20	55
21 - 25	47
26 - 30	40
31 - 35	33
36 - 40	27
41 - 45	21
46 - 50	15
51 - 55	13
56 - 60	11
61 - 65	9
66 - 70	8
71 and over	7

e. The policy shall provide that the variable death benefit shall reflect the investment experience of the variable life insurance separate account established and maintained by the insurer and that the excess, positive or negative, of the net investment return over the assumed investment rate, as applied to the benefit base of each variable life insurance policy, shall be used to provide either:

(1) fully paid-up variable life insurance providing coverage for the same period as the basic insurance under the policy or fully paid-up [fixed benefit] term insurance amounts <u>for a term of annual periods of not less than one year nor more than five years,</u> positive or negative, as the case may be, or a combination thereof; or

(2) variable life insurance amounts, positive or negative, as the case may be, so that the reserve maintains the same percentage relationship to the variable death benefit as it would have on a corresponding fixed benefit policy.

f. Each variable life insurance policy shall be credited with the full amount of the net investment return applied to the benefit base.

g. Changes in variable death benefits of each variable life insurance policy shall be determined at least annually.

h. The cash value of each variable life insurance policy shall be determined at least monthly. The method of computation of cash values and other non-forfeiture benefits, as described either in the policy or in a statement filed with the Commissioner of the state in which the policy is delivered, or issued for delivery, shall be in accordance with actuarial procedures that recognize the variable nature of the policy. The method of computation must be such that, if the net investment return credited to the policy at all times from the date of issue should be equal to the assumed investment rate with premiums and benefits determined accordingly under the terms of the policy, then the resulting cash values and other non-forfeiture benefits must be at least equal to the minimum values required by Section ____ of the Insurance Laws of this state (Standard Non-Forfeiture Law) for a fixed benefit policy with such premiums and benefits. The assumed investment rate shall not exceed the maximum interest rate permitted under the Standard Non-Forfeiture Law of this state. The method of computation may disregard incidental minimum guarantees as to the dollar amounts payable. Incidental minimum guarantees include, for example, but are not to be limited to, a guarantee that the amount payable at death or maturity shall be at least equal to the amount that otherwise would have been payable if the net investment return credited to the policy at all times from the date of issue had been equal to the assumed investment rate.

i. The computation of values required for each variable life insurance policy may be based upon such reasonable and necessary approximations as are acceptable to the Commissioner.

j.* [f.] (1) If the gross premiums for any variable life insurance policy delivered or issued for delivery in this state produce an excess of (A) over (B) as defined in (2) below, the present value as of the date of issue of the adjusted premiums used in determining the minimum cash values required by Section 2h of Article IV shall be decreased by such excess by decreasing each adjusted premium by a uniform percentage.

(2) The excess of (A) over (B) referred to in subsection (1) above shall be determined as of the date of issue on the basis of the mortality table and maximum rate of interest permitted by Section —— of Insurance Laws of this state (Standard Non-Forfeiture Law); and

(A) is the present value of the gross premiums for the policy, decreased by one dollar per thousand of equivalent uniform amount for policies with an equivalent uniform amount of less than ten thousand, payable on an annual basis (exclusive of those portions of the gross premiums allocable to any incidental insurance benefits) by a person who meets standard underwriting requirements; and

(B) is the product of (1) times (2) where (1) is the present value of the maximum premium rates per thousand of insurance shown below payable at the beginning of each policy year to attained age 65 of the insured for issue ages below age 51, for fifteen years for issue ages 51 to 70 and for life for issue ages above age 70 and (2) is the ratio of (i) the present value of the benefits under the policy to (ii) the present value of an insurance of one thousand for the whole of life.

TABLE OF RATES

Age at Issue	Premium Rate	Age at Issue	Premium Rate
0	11.50	41	38.65
1	11.60	42	40.45
2	11.76	43	42.51
3	11.97	44	44.89
4	12.22	45	47.62
5	12.50	46	50.71
6	12.80	47	54.17
7	13.11	48	58.00
8	13.43	49	62.18
9	13.75	50	66.67
10	14.08	51	68.58
11	14.42	52	70.54
12	14.77	53	72.57
13	15.13	54	74.69
14	15.49	55	76.92
15	15.87	56	79.29
16	16.27	57	81.84
17	16.70	58	84.61
18	17.16	59	87.63
19	17.65	60	90.91
20	18.18	61	94.45
21	18.74	62	98.25
22	19.34	63	102.31
23	19.97	64	106.61
24	20.62	65	111.11
25	21.28	66	115.48
26	21.95	67	119.39
27	22.64	68	122.51
28	23.37	69	124.50
29	24.15	70	125.00
30	25.00	71	118.86
31	25.92	72	123.96
32	26.91	73	129.66
33	27.97	74	135.96
34	29.10	75	142.86
35	30.30	76	150.36
36	31.55	77	158.46
37	32.84	78	167.16
38	34.17	79	176.46
39	35.56	80	186.36
40	37.04		

(3) For purposes of this Section, any portion of the premium set aside to support a guarantee that any surrender value shall not be less than a specified amount or for any other benefit that the Commissioner shall deem to be excludable, shall not be included.

*This section is not new. It has been moved from former Article IV Sec. 3 f.

k. In determining the net investment return to be applied to the benefit base the insurer may deduct only the charges described in paragraphs (1), (2), (4), and (5) of Article VI, Section 7a.

3. Mandatory Policy Provisions: Every variable life insurance policy filed for approval in this state shall contain at least the following:

a. the cover page or pages corresponding to the cover page of each such policy shall contain:

(1) a prominent statement in either contrasting color or in boldface type at least four points larger than the type size of the largest type used in the text of any provision on that page, that the death benefit may be variable or fixed under specified conditions;

(2) a prominent statement in either contrasting color or in boldface type at least four points larger than the type size of the largest type size used in the text of any provision on that page, that cash values may increase or decrease in accordance with the experience of the separate account subject to any specified minimum guarantees;

(3) a statement that the minimum death benefit will be at least equal to the initial face amount at the date of issue if premiums are duly paid [when due] and if there are no outstanding policy loans, partial withdrawals, or partial surrenders;

(4) the rule, or a reference to the policy provision, which describes the method for determining the variable amount of insurance payable at death;

(5) a captioned provision which provides that the policyholder may return the variable life insurance policy within 45 days of the date of the execution of the application or within 10 days of receipt of the policy by the policyholder, whichever is later, and receive a refund of all premium payments for such policy; and

(6) such other items as are currently required for fixed benefit life insurance policies and which are not inconsistent with this regulation.

b. a provision for a grace period of not less than thirty-one days from the premium due date which shall provide that where the premium is paid within the grace period, policy values will be the same, except for the deduction of any overdue premium, as if the premium were paid on or before the due date;

c. a provision that the policy will be reinstated at any time within two years from the date of default upon the written application of the insured and evidence of insurability, including good health, satisfactory to the insurer, unless the cash surrender value has been paid or the period of extended insurance has expired, upon the payment of any outstanding indebtedness arising subsequent to the end of the grace period following the date of default together with accrued interest thereon to the date of reinstatement and payment of an amount not exceeding the greater of:

(1) all overdue premiums and any other indebtedness in effect at the end of the grace period following the date of default with interest at a rate not exceeding __ percent[8] per annum compounded annually; or

(2) 110% of the increase in cash surrender value resulting from reinstatement.

d. a full description of the benefit base and of the method of calculation and application of any factors used to adjust variable benefits under the policy;

e. a provision designating the separate account to be used and stating that:

(1) such separate account shall be used to fund only variable life insurance benefits, except to the extent permitted by Section 5c(6) of this Article;

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8. DRAFTING NOTE: Each state should [fill this blank with its maximum permissible policy loan interest rate] word this provision to reflect the maximum permissible rates of interest for reinstatement and policy loans, if state law provides therefor. E. g., if one rate applies to both, such rate should be inserted in the blank space. If a state has different rates, then in the text of 3c(1), after "per annum" insert "for overdue premiums and at a rate not exceeding ____ percent per annum on indebtedness," filling the blanks accordingly.

(2) the assets of such separate account shall be available to cover the liabilities of the general account of the insurer only to the extent that the assets of the separate account exceed the liabilities of the separate account arising under the variable life insurance policies supported by the separate account; and

(3) the assets of such separate account shall be valued at least as often as any policy benefits vary but at least monthly.

* [f. (1) If the gross premiums for any variable life insurance policy delivered or issued for delivery in this state produce an excess of (A) over (B) as defined in (2) below, the present value as of the date of issue of the adjusted premiums used in determining the minimum cash values required by Section 2h of Article IV shall be decreased by such excess by decreasing each adjusted premium by a uniform percentage.

(2) The excess of (A) over (B) referred to in subsection (1) above shall be determined as of the date of issue on the basis of the mortality table and maximum rate of interest permitted by Section —— of Insurance Laws of this state (Standard Non-Forfeiture Law); and

(A) is the present value of the gross premiums for the policy, decreased by one dollar per thousand of equivalent uniform amount for policies with an equivalent uniform amount of less than ten thousand, payable on an annual basis (exclusive of those portions of the gross premiums allocable to any incidental insurance benefits) by a person who meets standard underwriting requirements; and

(B) is the product of (1) times (2) where (1) is the present value of the maximum premium rates per thousand of insurance shown below payable at the beginning of each policy year to attained age 65 of the insured for issue ages below age 51, for fifteen years for issue ages 51 to 70 and for life for issue ages above age 70 and (2) is the ratio of (i) the present value of the benefits under the policy to (ii) the present value of an insurance of one thousand for the whole of life.

TABLE OF RATES

Age at Issue	Premium Rate	Age at Issue	Premium Rate
0	11.50	41	38.65
1	11.60	42	40.45
2	11.76	43	42.51
3	11.97	44	44.89
4	12.22	45	47.62
5	12.50	46	50.71
6	12.80	47	54.17
7	13.11	48	58.00
8	13.43	49	62.18
9	13.75	50	66.67
10	14.08	51	68.58
11	14.42	52	70.54
12	14.77	53	72.57
13	15.13	54	74.69
14	15.49	55	76.92
15	15.87	56	79.29
16	16.27	57	81.84
17	16.70	58	84.61
18	17.16	59	87.63
19	17.65	60	90.91
20	18.18	61	94.45
21	18.74	62	98.25
22	19.34	63	102.31
23	19.97	64	106.61
24	20.62	65	111.11
25	21.28	66	115.48
26	21.95	67	119.39
27	22.64	68	122.51
28	23.37	69	124.50
29	24.15	70	125.00
30	25.00	71	118.86
31	25.92	72	123.96
32	26.91	73	129.66
33	27.97	74	135.96
34	29.10	75	142.86
35	30.30	76	150.36
36	31.55	77	158.46
37	32.84	78	167.16
38	34.17	79	176.46
39	35.56	80	186.36
40	37.04		

(3) For purposes of this Section, any portion of the premium set aside to support a guarantee that any surrender value shall not be less than a specified amount or for any other benefit that the Commissioner shall deem to be excludable, shall not be included.]

*This section is not deleted but rather is moved to Art. IV Sec 2j.

**f. [g.] [The policy shall also contain] a provision that at any time during the first eighteen months of the variable life insurance policy, the owner may exchange the policy for a policy of permanent fixed benefit insurance for the same initial amount of insurance as the variable life insurance policy, provided that the new policy:

(1) shall bear the same date of issue and age at issue as the original variable life insurance policy;

(2) is issued on any plan of permanent insurance offered by the insurer or an affiliate on the date of issue of the variable life insurance policy and premium rates in effect on that date for the same class of insurance;

(3) include such riders and incidental insurance benefits as were included in the original policy if such riders and incidental insurance benefits are issued with the fixed benefit policy. If the conversion results in an increase or decrease in cash value, such increase or decrease will be payable to the insurer or the insured as the case may be.

(4) [The insurer] must apply as an advance premium [on the new policy] any excess of the accrued premium on the original variable life insurance policy from the date of issue to the date of request for exchange over the corresponding accrued premium on the new fixed benefit policy, except that any portion of such excess which is less than a regular mode premium on the new policy may either be applied as an advance premium or refunded in cash at the option of the insurer.

(5) [The insurer] shall not require evidence of insurability for this exchange.

***AWAITING PROPOSED TECHNICAL AMENDMENTS*

g. [h.] a provision that the policy and any papers attached thereto by the insurer, including the application if attached, constitute the entire insurance contract;

h. [i.] a designation of the officers of the insurer who are empowered to make an agreement or representation on behalf of the insurer and an indication that statements by the insured, or on his behalf, shall be considered as representations and not warranties;

i. [j.] an identification of the owner of the insurance contract;

j. [k.] a provision setting forth conditions or requirements as to the designation, or change of designation, of a beneficiary and a provision for disbursement of benefits in the absence of a beneficiary designation;

k. [l.] a statement of any conditions or requirements concerning the assignment of the policy;

l. [m.] a description of any adjustments in policy values to be made in the event of misstatement of age or sex of the insured;

m. [n.] a provision that the policy shall be incontestable by the insurer after it has been in force for two years during the lifetime of the insured;

n. [o.] a provision stating that the investment policy of the separate account shall not be changed without the approval of the Insurance Commissioner of the state of domicile of the insurer, and that the approval process is on file with the Commissioner of this state;

o. [p.] a provision that payment of variable death benefits in excess of the minimum death benefits, cash values, policy loans, or partial withdrawals (except when used to pay premiums) or partial surrenders may be deferred:

(1) for up to six months from the date of request; or

(2) for any period during which the New York Stock Exchange is closed for trading (except for normal holiday closing) or when the Securities and Exchange Commission has determined that a state of emergency exists which may make such payment impractical.

p. [q.] Settlement options which shall be provided on a fixed basis only;

q. [r.] a description of the basis for computing the cash surrender value under the policy shall be included. Such surrender value may be expressed as either:

(1) a schedule of cash value amounts per one thousand dollars of variable face amount at each attained age or policy year for at least 20 years from issue, or for the premium paying period, if less than 20 years; or

(2) one cash value schedule as described in paragraph (1) for the death benefit, or for each one thousand dollars of death benefit, which would be in effect if the net investment return is always equal to the assumed investment rate and a second schedule applicable to any adjustments to the death benefit (disregarding the minimum death benefit guarantee and term insurance amounts) if the net investment return does not equal the assumed investment rate at each age for at least 20 years from issue, or for the premium paying period if it is less than 20 years.

r. [s.] Premiums for incidental insurance benefits shall be stated separately;

s. [t.] any other policy provisions requi by this regulation;

t. [u] such other items as are currently required for fixed benefit life insurance policies and are not inconsistent with this regulation.[9]

4. Non-Forfeiture, Partial Withdrawal, Policy Loan, and Partial Surrender Provisions: Every variable life insurance policy delivered or issued for delivery in this state shall contain provisions which are not less favorable to the policyholder than the following:

a. A provision for non-forfeiture insurance benefits so that at least one such benefit is offered on a fixed basis from the due date of the premium in default.

(1) Variable extended term insurance may not be offered.

(2) A given non-forfeiture option need not be offered on both a fixed and a variable basis.

(3) The insurer may establish a reasonable minimum cash surrender value below which any such non-forfeiture insurance options will not be available.

b. A provision for policy loans (which may at the option of the insurer be entitled and referred to as a partial withdrawal provision) not less favorable to the policyholder than the following:

(1) Up to 75% but if the loan is made from the general account not more than 90% of the policy's cash value may be borrowed;

(2) The amount borrowed, or any repayment thereof, shall not affect the amount of the premium payable under the policy.

(3) The amount borrowed shall bear interest at a rate not to exceed___ %[10] per year compounded annually.

(4) Any indebtedness shall be deducted from the proceeds payable on death. [after the exercise of the policy loan provision shall equal the greater of the minimum death benefit or the variable death benefit, less the indebtedness outstanding.]

(5) Any indebtness shall be deducted from the cash value upon surrender or in determining any non-forfeiture benefit.

(6) Whenever the indebtedness exceeds the cash value, the insurer shall give notice of intent to cancel the policy if the excess indebtedness is not repaid within thirty-one days after the date of mailing of such notice.

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9. DRAFTING NOTE: The provisions of this Section having corresponding provisions in fixed life insurance regulation should be revised to conform to those corresponding provisions to the extent appropriate.

10. DRAFTING NOTE: Each state should fill this blank with its maximum permissible policy loan interest rate.

(7) The policy may provide that if, at any time, so long as premiums are duly paid, the variable death benefit is less that it would have been if no loan or withdrawal had ever been made, the policyholder may increase such variable death benefit up to what it would have been if there had been no loan or withdrawal by paying an amount not exceeding 110% of the corresponding increase in cash value and by furnishing such evidence of insurability as the insurer may request.

(8) The policy may specify a reasonable minimum amount which may be borrowed at any time but such minimum shall not apply to any automatic premium loan provision.

(9) No policy loan provision is required if the policy is under the extended insurance non-forfeiture option.

(10) In addition to the foregoing, the policy may contain a partial surrender provision; however, any such provision shall provide that the policyholder may request part of the cash value and both the variable and minimum death benefits will be reduced in proportion to the percentage of the cash value received by the policyholder and the premium for the remaining amount of insurance will also be reduced to the appropriate rates for the reduced amount of insurance. The policy may provide that a partial surrender provision shall not require the insurer to reduce the amount of the minimum death benefit to less than the lowest amount of minimum death benefit which would have been issued to the insured under the insurance plans of the insurer at the time the policy was issued. The policy must clearly provide that the policyholder has the option of electing to exercise the cash value privileges of the policy loan or partial withdrawal provision rather than the partial surrender provision.

(11) All policy loan, partial withdrawal, or partial surrender provisions shall be constructed so that variable life insurance policyholders who have not exercised such provision are not disadvantaged by the exercise thereof.

(12) Monies paid to the policyholders upon the exercise of any policy loan, partial withdrawal, or partial surrender provision shall be withdrawn from the separate account and shall be returned to the separate account upon repayment except that a stock insurer may provide the monies for policy loans from the general account.

5. Other Policy Provisions: The following provisions may in substance be included in a variable life insurance policy or related form delivered or issued for delivery in this state:

a. An exclusion for suicide within [two]___years of the policy issue date;

b. incidental insurance benefits may be offered on a fixed basis only;

c. policies issued on a participating basis shall offer to pay dividend amounts in cash. In addition, such policies may offer the following dividend options:

(1) the amount of the dividend may be credited against premium payments;

(2) the amount of the dividend may be applied to provide paid-up amounts of additional fixed benefit whole life insurance;

(3) the amount of the dividend may be applied to provide paid-up amounts of additional variable life insurance;

(4) the amount of the dividend may be deposited in the general account at a specified minimum rate of interest;

(5) the amount of the dividend may be applied to provide paid-up amounts of fixed benefit one-year term insurance;

(6) the amount of the dividend may be deposited as a variable deposit in the separate account if the separate account is [in the case of variable life insurance policies] exempt pursuant to Section 3(c)(11) of the Investment Company Act of 1940. [because of their tax qualified status.]

d. A provision allowing the policyholder to elect in writing in the application for the policy or thereafter an automatic premium loan on a basis not less favorable than that required of policy loans or partial withdrawals under Section 4 of this Article, except that a restriction that no more than two consecutive premiums can be paid under this provision may be imposed.

ARTICLE V: RESERVE LIABILITIES FOR VARIABLE LIFE INSURANCE

1. Reserve liabilities for variable life insurance policies shall be established under the Standard Valuation Law in accordance with actuarial procedures that recognize the variable nature of the benefits provided and any mortality guarantees.

2. Reserve liabilities for the guaranteed minimum death benefit shall be the reserve needed to provide for the contingency of death occurring when the guaranteed minimum death benefit exceeds the death benefit that would be paid in the absence of the guarantee, and shall be maintained in the general account of the insurer and shall be not less than the greater of the following minimum reserves:

a. The aggregate total of the term costs, if any, covering a period of one full year from the valuation date, of the guarantee on each variable life insurance contract, assuming an immediate one-third depreciation in the current value of the assets of the separate account followed by a net investment return equal to the assumed investment rate; or

b. The aggregate total of the "attained age level" reserves on each variable life insurance contract. The "attained age level" reserve on each variable life insurance contract shall not be less than zero and shall equal the "residue," as described in paragraph (1), of the prior year's "attained age level" reserve on the contract, with any such "residue" increased or decreased by a payment computed on an attained age basis as described in paragraph (2) below.

(1) the "residue" of the prior year's "attained age level" reserve on each variable life insurance contract shall not be less than zero and shall be determined by adding interest at the valuation interest rate to such prior year's reserve, deducting the tabular claims based on the "excess," if any, of the guaranteed minimum death benefit over the death benefit that would be payable in the absence of such guarantee, and dividing the net result by the tabular probability of survival. The "excess" referred to in the preceding sentence shall be based on the actual level of death benefits that would have been in effect during the preceding year in the absence of the guarantee, taking appropriate account of the reserve assumptions regarding the distribution of death claim payments over the year.

(2) the payment referred to in Subsection 2b of this Article shall be computed so that the present value of a level payment of that amount each year over the future premium paying period of the contract is equal to (A) minus (B) minus (C), where (A) is the present value of the future guaranteed minimum death benefits, (B) is the present value of the future death benefits that would be payable in the absence of such guarantee, and (C) is any "residue," as described in paragraph (1), of the prior year's "attained age level" reserve on such variable life insurance contract. If the contract is paid-up, the payment shall equal (A) minus (B) minus (C). The amounts of future death benefits referred to in (B) shall be computed assuming a net investment return of the separate account which may differ from the assumed investment rate and/or the valuation interest rate but in no event may exceed the maximum interest rate permitted for the valuation of life insurance contracts.

c. The valuation interest rate and mortality table used in computing the two minimum reserves described in (a) and (b) above shall conform to permissible standards for the valuation of life insurance contracts. In determining such minimum reserve, the company may employ suitable approximations and estimates, including but not limited to groupings and averages.[11]

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11. DRAFTING NOTE: At the December, 1972 meeting of the NAIC, this Section was adopted as an amendment to the model variable contract regulation with a proviso that the reserve calculation basis would be applicable for a five-year period only. The minutes of the (C4) Subcommittee indicate that the amendment was adopted "in order that a basis for reserves could be created now and that results of the accumulated statistics over a five-year period would be available for testing and credibility".

3. Reserve liabilities for all fixed incidental insurance benefits shall be maintained in the general account in amounts determined in accordance with the actuarial procedures appropriate to such benefit.

ARTICLE VI: SEPARATE ACCOUNTS

The following requirements apply to the establishment and administration of variable life insurance separate accounts:

1. Establishment and Administration of Separate Accounts: An insurer issuing variable life insurance in this state shall establish one or more separate accounts pursuant to Sections ___ of the Insurance Laws of this state.

   a. If no law or other regulation provides for the custody of separate account assets and if the insurer itself is not the custodian of such assets, all contracts for such custody shall be in writing and the Commissioner of the insurer's state of domicile shall approve of both the terms of any such contract and the proposed custodian prior to the transfer of custody.

   b. An insurer shall not without the prior written approval of the Commissioner employ in any material connection with the handling of separate account assets any person who:[12]

      (1) within the last ten years has been convicted of any felony or a misdemeanor arising out of such person's conduct involving embezzlement, fraudulent conversion, or misappropriation of funds or securities or involving violation of Sections 1341, 1342, or 1343 of Title 18, United States Code; or

      (2) within the last ten years has been found by any state regulatory authority to have violated or has acknowledged violation of any provision of any state insurance law involving fraud, deceit, or knowing misrepresentation; or

      (3) within the last ten years has been found by federal or state regulatory authorities to have violated or has acknowledged violation of any provision of federal or state securities laws involving fraud, deceit, or knowing misrepresentation.

   c. All persons with access to the cash, securities, or other assets of the separate account shall be under bond in an amount of not less than $_____ .

   d. If an insurer establishes more than one separate account for variable life insurance, justification for the establishment of each additional separate account shall also be filed with the Commissioner and shall be subject to his approval. The creation of additional separate accounts to avoid lower maximum charges against the separate account is prohibited.

   e. The assets of such separate accounts established for variable life insurance policies shall be valued at least as often as variable benefits are determined but in any event at least monthly.

   f. [The same separate account shall not be used to fund both variable life insurance policies which are] A separate account exempt pursuant to Section 3(c)(11) of the Investment Company Act of 1940 because ~~of~~ [their] the tax qualified status of the policies funded thereby shall not be used to fund [and] other variable life insurance policies. [not so exempt.]

   g. Except for separate accounts exempt pursuant to Section 3(c)(11) of the Investment Company Act of 1940, [as provided in Section 5c(6) of Article IV,] variable life insurance separate accounts shall not be used for variable annuities or for the investment of funds corresponding to dividend accumulations or other policyholder liabilities not involving life contingencies.

2. Amounts in the Separate Account

   a. The insurer shall maintain in each variable life insurance separate account assets with a fair market value at least equal to the greater of the valuation reserves for the variable portion of the variable life insurance policies or the benefit base for such policies.

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12. DRAFTING NOTE: This subsection should be modified to conform to state laws concerning previous convictions, if necessary.

b. The benefit base of any variable life insurance policy as of the beginning of any valuation period shall not be less than the sum of the following factors after deducting amounts of any indebtedness pursuant to Section 4b of Article IV:

(1) the valuation net premium for such period, [based upon the initial amount insured;] for the variable portion of the policy minus the discounted cost of term insurance for such period, based on the tabular mortality and interest rates used in determining valuation reserves; and

(2) the valuation terminal reserve, for the variable portion of the policy, at the end of the immediately preceding valuation period adjusted for the net investment return of such preceding period. [based upon the amount insured at the end of such period less the discounted cost of term insurance for the next period based upon tabular mortality and the interest rate used for such valuation reserves.]

c. In lieu of the minimum benefit base requirement specified above, an insurer may otherwise qualify under this Section if it can be demonstrated, to the satisfaction of the Commissioner, that the policy benefits obtained over a 20-year period from the date of issue by the use of the insurer's benefit base are at least substantially equivalent in value to the benefits obtained by the use of the minimum benefit base specified above. The Commissioner may specify the range of net investment return to be used in this demonstration.

d. Notwithstanding the actual reserve basis used for policies that do not meet standard underwriting requirements, the benefit base for such policies may be the same as for corresponding policies which do meet standard underwriting requirements.

3. Investments by the Separate Account

a. No sale, exchange, or other transfer of assets may be made by an insurer or any of its affiliates between any of its separate accounts or between any other investment account and one or more of its separate accounts unless:

(1) in case of a transfer into a separate account, such transfer is made solely to establish the account or to support the operation of the policies with respect to the separate account to which the transfer is made; and

(2) such transfer, whether into or from a separate account, is made by a transfer of cash; but other assets may be transferred if approved by the Commissioner in advance.

b. Assets allocated to a variable life insurance separate account shall be held in cash or investments having a reasonably ascertainable market price. For purposes of this subsection, only the following shall be considered "investments having a reasonably ascertainable market price:"

(1) liens in favor of the insurer against separate account policy reserves resulting from use by policyholders of cash values;

(2) securities listed and traded on the New York Stock Exchange, the American Stock Exchange, or regional stock exchanges or successors to such exchanges having the same or similar qualifications;

(3) securities listed on the NASDAQ System;

(4) shares of an investment company registered pursuant to the Investment Company Act of 1940. Where such an investment company issues book shares in lieu of share certificates, such book shares shall be deemed to be adequate evidence of ownership;

(5) obligations of or guaranteed by the United States Government, the Canadian government, any state, or municipality or governmental subdivision of a state;

(6) commercial paper issued by business corporations when the total of such paper issued by the corporation does not exceed in value a guaranteed short line of credit by a bank;

(7) certificates of deposit issued by financial institutions the deposits of which are insured by the FDIC or FSLIC; and

(8) new bond or debt issues which may reasonably be expected to be listed on an exchange regulated by the Securities Exchange Act of 1934.

c. Notwithstanding any other provision of law or the provisions of subsection b above, assets allocated to a variable life insurance separate account shall not be invested in:

(1) commodities or commodity contracts;

(2) put and call options or combinations of such options;

(3) short sales;

(4) purchases on margins;

(5) letter or restricted stock;

(6) units or other evidences of ownership of a separate account of another insurer, except those registered under the Investment Company Act of 1940; or

(7) real estate other than shares of a real estate investment trust listed as described in subsection (2) above.

4. Limitations on Ownership

a. A variable life insurance separate account shall not purchase or otherwise acquire the securities of any issuer, other than securities issued or guaranteed as to principal and interest by the United States, if immediately after such purchase or acquisition the value of such investment, together with prior investments of such separate account in such security valued as required by these regulations, would exceed 10% of the value of the assets of the separate account. The Commissioner may waive this limitation in writing if he believes such waiver will not render the operation of the separate account hazardous to the public or the policyholders in this state.

b. No separate account shall purchase or otherwise acquire the voting securities of any issuer if as a result of such acquisition the insurer and its separate accounts, in the aggregate, will own more than 10% of the total issued and outstanding voting securities of such issuer. The Commissioner may waive this limitation in writing if he believes such waiver will not render the operation of the separate account hazardous to the public or the policyholders in this state or jeopardize the independent operation of the issuer of such securities.

c. The percentage limitation specified in subsection a of this Section shall not be construed to preclude the investment of the assets of separate accounts in shares of investment companies registered pursuant to the Investment Company Act of 1940 if the investments and investment policies of such investment companies comply substantially with the provisions of Section 3 of this Article and other applicable portions of this regulation.

5. Valuation of Assets of a Variable Life Insurance Separate Account

a. Investments of the separate account shall be valued at their market value on the date of valuation.

(1) Market value for investments traded on the recognized exchanges means the last reported sale price on the date of valuation. If there has been no sale on that date, the market value means the last reported bid quotation on the date of valuation.

(2) Market value for investments listed on the NASDAQ System means the last representative bid quotation on the valuation date. If an investment ceases to be listed but continues to be traded over the counter, it shall be valued at the lowest bid quotation as it appears on the National Quotation Bureau sheets.

(3) If the valuation date referred to in paragraphs (1) and (2) above is a day when the exchange or the NASDAQ System is not open for business, the valuation date shall be the last date when the exchange or the NASDAQ System was open for business.

b. If an investment ceases to be traded, it shall be valued at fair value as determined in good faith by or at the direction of the Board of Directors of the insurer but not in excess of the last reported bid quotation.

Within thirty days notification of cessation of trading of any investment shall be reported by the insurer to the Insurance Commissioner of the state of domicile of the insurer. Such Commissioner shall within a reasonable period of time determine the method of valuation or disposition of such investment.

6. Separate Account Investment Policy

a. The investment policy of a separate account operated by a domestic insurer filed under Section 2c of Article III shall not be changed without the approval of the Insurance Commissioner.

b. With respect to changes of investment policy for which the Commissioner must give his approval, the following regulations shall apply:

(1) Such approval shall be deemed to be given sixty days after the date the request for approval was filed with the Commissioner, unless he notifies the insurer before the end of such sixty-day period of his determination that the proposed change is a material change in the investment policy.

(2) If the change is deemed material by the Commissioner, he shall approve such change only if he determines, after a public hearing, that the change does not appear detrimental to the interest of the policyholders of the insurer.

(3) At least thirty days prior to any public hearing under paragraph (2), the insurer shall mail a notice to each policyholder and to the Insurance Commissioner of each state in which the affected variable life insurance policies are being sold. Such notice shall describe the proposed change in investment policy, list the reasons therefor, designate the date and place of the public hearing, inform the policyholder of the procedures to be followed in commenting on the change, and describe the conduct of the meeting. Any such notice shall be in a form approved by the Commissioner.

(4) Within sixty days after such public hearing, the Commissioner must approve or deny the proposed change in investment policy.

(5) Should any policyholder object to the proposed change and the change is allowed by the Commissioner, the objecting policyholder shall be given the option within sixty days of notification to the policyholder of the approval by the Commissioner of such change, of converting, without evidence of insurability, under one of the following options, to a fixed benefit life insurance policy issued by the insurer or an affiliate:

(A) If the policy is in force on a premium paying basis, either:

(i)[a] conversion as of the original issue age to a substantially comparable permanent form of fixed benefit life insurance, based on the insurer's premium rates for fixed benefit life insurance at the original issue age, for an amount of insurance not exceeding the death benefit of the variable life insurance policy on the date of conversion [. If the cash value of the variable life insurance policy exceeds the cash value of the fixed life insurance policy, the difference shall be paid to the policyholder. If the cash value of the fixed life insurance policy exceeds the cash value of the variable life insurance policy, the difference shall be paid by the policyholder;] or

[(B) surrender of the variable life insurance policy and]

(ii) conversion as of the attained age to a substantially comparable permanent form of fixed benefit life insurance for an amount of insurance not exceeding the excess of the death benefit of the variable life insurance policy on the date of conversion over:

[(i)] (aa) its cash value on the date of conversion [if the withdrawing policyholder elects the cash surrender option] if the policyholder elects to surrender the variable life policy for its cash value, or

[(ii)] (bb) the death benefit payable under any paid-up insurance option [if the withdrawing policyholder elects such option] if the policyholder elects such nonforfeiture option under the variable life policy.

(B) If the policy is in force as paid-up variable life insurance, then conversion will be to a substantially comparable paid-up fixed benefit life insurance policy for an amount of insurance not exceeding the death benefit of the variable life insurance policy on the date of conversion.

If conversion is made pursuant to (A)(i) or (B) above, then (1) if the cash value of the variable life insurance policy exceeds the cash value of the fixed benefit life insurance policy, the difference shall be paid to the policyholder; (2) if the cash value of the fixed benefit life insurance policy exceeds the cash value of the variable life insurance policy, the difference shall be paid by the policyholder; and (3) any indebtedness under the variable life insurance policy shall become indebtedness under the fixed benefit policy, provided that any excess of such indebtedness over the cash value of the fixed benefit policy on the date of conversion shall be deducted from any amount otherwise payable to the policyholder.

7. Charges Against a Variable Life Insurance Separate Account

a. The insurer may deduct only the following from the separate account:

(1) taxes or reserves for taxes attributable to investment gains and income of the separate account;

(2) actual cost of reasonable brokerage fees and similar direct acquisition and sales costs incurred in the purchase or sale of separate account assets;

(3) actuarially determined costs of insurance (tabular costs) and the release of reserves and benefit base consistant with the release of separate account liabilities; [on the termination or partial surrender of the variable life insurance policy;]

(4) charges for investment management expenses, including internal costs attributable to the investment management of assets of the separate account, not exceeding the following percentages, on an annual basis, of the average net asset value of the separate account as of the dates of valuation under Section 1e of this Article:

(A) .75% of that portion of separate account assets valued at or under $75,000,000; and

(B) .50% of that portion of separate account assets valued in excess of $75,000,000 but less than $150,000,000; and

(C) .40% of that portion of separate account assets valued in excess of $150,000,000 but less than $400,000,000; and

(D) .35% of that portion of separate account assets valued in excess of $400,000,000 but less than $800,000,000; and

(E) .30% of that portion of separate account assets valued in excess of $800,000,000.

(5) A charge, at a rate specified in the policy, not to exceed .50% per year of the average net asset value of the separate account as of the dates of valuation under Section 1e of this Article, for mortality and expense guarantees.

(6) Any amounts in excess of those required to be held in the separate account.

b. Any charges against the separate account made by either an affiliate of the insurer or an unaffiliated fund shall be considered part of the charges limited by paragraphs (4) and (5) of subsection a above. Any charge against the separate account, excluding taxes, shall not vary in accordance with the difference between the investment performance of the separate account and any index of securities prices or other measure of investment performance.

8. Standards of Conduct: Every insurer seeking approval to enter into the variable life insurance business in this state shall adopt by formal action of its Board of Directors and file with the Commissioner a written statement specifying the Standards of Conduct of the insurer, its officers, directors, employees, and affiliates with respect to investments of variable life insurance separate accounts and variable life insurance operations. Such Standards of Conduct shall be binding on the insurer and those to whom it refers and must contain at a minimum the items contained in subsection 9b of this Article.

9. Conflicts of Interest

a. Rules under any provision of the Insurance Laws of this state or any regulation applicable to the officers and directors of insurance companies with respect to conflicts of interest shall also apply to members of any separate account's committee or other similar body. No officer or director of such company nor any member of any managing committee or body of a separate account shall receive directly or indirectly any commission or any other compensation with respect to the purchase or sale of assets of such separate account. The Board of Directors of the insurer shall be responsible for all acts concerning the separate account.

b. Unless otherwise approved in writing by the Commissioner in advance of the transaction, with respect to variable life insurance separate accounts, an insurer or affiliate thereof shall not:

(1) sell to or purchase from any such separate account established by the insurer any securities or other property, other than variable life insurance policies;

(2) purchase or allow to be purchased for any such separate account any securities of which the insurer or an affiliate is the issuer;

(3) accept any compensation, other than a regular salary or wages from such insurer or affiliate, for the sale or purchase of securities to or from any such separate account other than as provided in Section 9c(3) of this Article;

(4) engage in any joint transaction, participation, or common undertaking whereby such insurer or an affiliate participates with such a separate account in any transaction in which an insurer or any of its affiliates obtains an advantage in the price or quality of the item purchased, in the service received, or in the cost of such service and the insurer or any of its other affiliates is disadvantaged in any of these respects by the same transaction;

(5) borrow money or securities from any such separate account other than under a policy loan provision.

c. No provision of this regulation shall be construed to prohibit:

(1) the investment of separate account assets in securities issued by one or more investment companies registered pursuant to the Investment Company Act of 1940 which is sponsored or managed by the insurer or an affiliate, and the payment of investment management or advisory fees on such assets;

(2) the combination of orders for the purchase or sale of securities for the insurer, an affiliate thereof, any separate accounts, or any one or more of them, which is for their mutual benefit or convenience so long as any securities so purchased or the proceeds of any sale thereof are allocated among the participants on some predetermined basis expressed in writing which is designed to assure the equitable treatment of all participants;

(3) an insurer or an affiliate to act as a broker or dealer in connection with the sale of securities to or by such separate account; however, any commission fee or remuneration charged therefor shall not exceed the minimum broker's commission established for any such transaction by any national securities exchange through which such transaction could be effected, or where such charges are subject to negotiation or where no minimum charge is applicable, then such charge shall be consistant with the charges prevailing[,] in the ordinary course of business in the community where such transaction is effected;

(4) the rendering of investment management or investment advisory services by an insurer or affiliate, for a fee, subject to the provisions of this regulation.

d. The Commissioner may, upon the written request of an insurer or an affiliate, approve a particular transaction or series of proposed transactions which would otherwise be prohibited under subsection b if he determines such transaction is not unfair or inequitable to persons affected under the circumstances of such transactions.

10. Investment Advisory Services to a Separate Account

a. An insurer shall not enter into a contract under which any person undertakes, for a fee, to regularly furnish investment advice to such insurer with respect to its separate accounts maintained for variable life insurance policies unless:

(1) the person providing such advice is registered as an investment adviser under the Investment Advisers Act of 1940; or

(2) the insurer has filed with the Commissioner and continues to file annually the following information and statements concerning the proposed adviser:

(A) the name and form of organization, state of organization, and its principal place of business;

(B) the names and addresses of its partners, officers, directors, and persons performing similar functions or, if such an investment adviser be an individual, of such individual;

(C) a written Standard of Conduct complying in substance with the requirements of Section 8 of this Article which has been adopted by the investment adviser and is applicable to the investment adviser, its officers, directors, and affiliates;

(D) a statement provided by the proposed adviser as to whether the adviser or any person associated therewith:[13]

(i) has been convicted within ten years of any felony or misdemeanor arising out of such person's conduct as an employee, salesman, officer or director of an insurance company, a bank, an insurance agent, a securities broker, or an investment adviser; involving embezzlement, fraudulent conversion, or misappropriation of funds or securities, or involving the violation of Sections 1341, 1342, or 1343 of Title 18 of the United States Code;

(ii) has been permanently or temporarily enjoined by order, judgement, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, or dealer, or as an affiliated person or as an employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity;

(iii) has been found by federal or state regulatory authorities to have willfully violated or has acknowledged willful violation of any provision of federal or state securities laws or state insurance laws or of any rule or regulation under any such laws; or

(iv) has been censured, denied an investment adviser registration, had a registration as an investment adviser revoked or suspended, or been barred or suspended from being associated with an investment adviser by order of federal or state regulatory authorities; and

(3) such investment advisory contract shall be in writing and provide that it may be terminated by the insurer without penalty to the insurer or the separate account upon no more than sixty days' written notice to the investment adviser.

b. The Commissioner may, after notice and opportunity for hearing, by order require such investment advisory contract to be terminated if he deems continued operation thereunder to be hazardous to the public [of] <u>or</u> the [insurance company's] <u>insurer's</u> policyholders.

ARTICLE VII: INFORMATION FURNISHED TO APPLICANTS

An insurer delivering or issuing for delivery in this state any variable life insurance policies shall deliver to the applicant for the policy, and obtain a written acknowledgement of receipt from such applicant coincident with or prior to the execution of the application, the following information. The requirements of this Article shall be deemed to have been satisfied by the delivery to the applicant of a prospectus included in a registration statement which satisfies the requirements of the Securities Act of 1933 and which was declared effective by the Securities and Exchange Commission to the extent that the prospectus contains the information required by this Article.

1. A summary explanation, in non-technical terms, of the principal features of the policy, including a description of the manner in which the variable benefits will reflect the investment experience of the separate account and the factors which affect such variation [;]<u>. Such explanation must include notices of the provision required by Article IV Sections 3a(5) and 3f;</u>

2. a statement of the investment policy of the separate account, including:

   a. a description of the investment objective and orientation intended for the separate account and the principal types of investments intended to be made; and

   b. any restriction or limitations on the manner in which the operations of the separate account are intended to be conducted.

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13. DRAFTING NOTE: This subparagraph should be modified to conform to state laws concerning previous convictions, if necessary.

3. A statement of the net investment return of the separate account for each of the last ten years for which the separate account was in existence;

4. a statement describing, as an approximate percentage of an annual gross premium for each year and for the life of the policy all commission or equivalent payments to be paid to all agents or other persons as a result of the proposed sale for each year of the policy for which such payments are to be made. As used in this Section, "commissions" means all monies and other valuable consideration, including but not limited to prizes, bonuses paid directly or indirectly to, for, or on behalf of the selling agent as compensation for services in the sale of variable life insurance;

5. a statement of the annual taxes, brokerage fees, and similar costs, and the charges, expressed as an annual percentage, levied against the separate account during the previous year;

6. a summary of the method to be used in valuing assets held by the separate account;

7. a summary of the federal income tax liabilities of the policy applicable to the insured, the policy owner, and the beneficiary;

8. if the applicant is furnished illustrations of benefits payable under any variable life insurance contract, such illustrations shall be prepared by the insurer and shall not include projections of past investment experience into the future or attempted predictions of future investment experience, provided that nothing contained herein prohibits use of hypothetical assumed rates of return to illustrate possible levels of benefits if it is made clear that such assumed rates are hypothetical only;

9. a prominent statement either in contrasting color or in boldface type at least four points larger than the type size of the largest type used in the text of any provision on the page,providing in substance the following information:

   The purpose of this variable life insurance policy is to provide insurance protection for the beneficiary named therein.

   No claim is made that this variable life insurance policy is in any way similar or comparable to a systematic investment plan of a mutual fund.

ARTICLE VIII: APPLICATIONS

The application for a variable life insurance policy shall contain:

1. a prominent statement that the death benefit may be variable or fixed under specified conditions;

2. a prominent statement that cash values may increase or decrease in accordance with the experience of the separate account (subject to any specified minimum guarantees);

3. questions designed to elicit information which enables the insurer to determine the suitability of variable life insurance for the applicant.

ARTICLE IX: REPORTS TO POLICYHOLDERS

Any insurer delivering or issuing for delivery in this state any variable life insurance policies shall mail to each variable life insurance policyholder at his or her last known address the following reports:

1. Within thirty days after each anniversary of the policy, a statement or statements of the cash surrender value, death benefit, any partial withdrawal or policy loan, any interest charge, and any optional payments allowed pursuant to Section 4 of Article IV under the policy computed as of the policy anniversary date. Provided, however, that such statement may be furnished within thirty days after a specified date in each policy year so long as the information contained therein is computed as of a date not more than forty-five days prior to the mailing of such notice. This statement shall state in contrasting color or distinctive type that, in accordance with the investment experience of the separate account, the cash values and the variable death benefit may increase or decrease, and shall prominently

identify any value described therein which may be recomputed prior to the next statement required by this Section. If the policy guarantees that the variable death benefit on the next policy anniversary date will not be less than the variable death benefit specified in such statement, the statement shall be modified to so indicate.

2. Annually, a statement or statements including:

a. a summary of the financial statement of the separate account based on the annual statement last filed with the Commissioner;

b. the net investment return of the separate account for the last year and, for each year after the first, a comparison of the investment rate of the separate account during the last year with the investment rate during prior years, up to a total of five years when available;

c. a list of investments held by the separate account as of a date not earlier than the end of the last year for which an annual statement was filed with the Commissioner;

d. any charges, taxes, and brokerage fees determined on an accrual basis payable by the separate account during the previous year, each expressed as a dollar amount and a percentage and the total expressed as a dollar amount and as a percentage, of the assets of the separate account;

e. a statement of the portfolio turnover rate as defined herein during the preceding fiscal year of investments allocated to the separate account.

(1) The rate shall be calculated by dividing (A) the lesser of purchases or sales of portfolio securities for the particular fiscal year by (B) the monthly average of the value of the portfolio securities owned by the separate account during the particular fiscal year. Such monthly average shall be calculated by totaling the values of the portfolio securities as of the beginning and end of the first month of the particular fiscal year and as of the end of each of the succeeding eleven months, and dividing the sum by 13, except that the average value of securities for which market quotations are not available may be based upon the value of such securities as of the end of the preceding fiscal quarters.

(2) For the purposes of this item, there shall be excluded from both the numerator and the denominator all U.S. Government securities (short-term and long-term) and all other securities whose maturities at the time of acquisition were one year or less. Purchases shall include any cash paid upon the conversion of one portfolio security into another. Purchases shall also include the cost of rights or warrants purchased. Sales shall include the net proceeds of the sale of rights or warrants. Sales shall also include the net proceeds of redemptions of portfolio securities by call or maturity.

(3) The insurer shall show, in addition to the calculated portfolio turnover rate, both the amount of the purchases and the amount of the sales (calculated as prescribed in (2) above) and the monthly average (but not the individual monthly figures) of the value of the portfolio securities owned by the separate account during the fiscal year.

(4) The insurer may, if it wishes, make any statement or explanation with respect to any significant variations in the portfolio turnover rate during the three fiscal years next preceding.

f. a statement of any change, since the last report, in the investment objective and orientation of the separate account, in any investment restriction or material quantitative or qualitative investment requirement applicable to the separate account, or in the investment adviser of the separate account;

g. the name of each broker or dealer handling portfolio transactions on behalf of the separate account in which the insurer or an affiliate has any material direct or indirect interest and the nature of such transactions and the amount of compensation received by each such broker or dealer from business originating with the separate account during the preceding fiscal year;

h. the names and principal occupations of each principal executive officer and each director of the insurer; and

i. the names of all parents of the insurer and the basis of control of the insurer, and the name of any person who is known to own, of record or beneficially, 10% or more of the outstanding voting securities of the company.

ARTICLE X: QUALIFICATION OF AGENTS FOR THE SALE OF VARIABLE LIFE INSURANCE

1. Qualification to Sell Variable Life Insurance

   a. No person may sell or offer for sale in this state any variable life insurance policy unless such person is an agent and has filed with the Commissioner, in a form satisfactory to the Commissioner, evidence that such person holds any license or authorization which may be required for the solicitation or sale of variable life insurance by any federal or state securities law.

   b. Any examination administered by the Department for the purpose of determining the eligibility of any person for licensing as an agent shall, after the effective date of this regulation, include such questions concerning the history, purpose, regulation, and sale of variable life insurance as the Commissioner deems appropriate.

2. Reports of Disciplinary Actions. Any person qualified in this state under this Article to sell or offer to sell variable life insurance shall immediately report to the Commissioner:

   a. any suspension or revocation of his agent's license in any other state or territory of the United States;

   b. the imposition of any disciplinary sanction, including suspension or expulsion from membership, suspension, or revocation of or denial of registration, imposed upon him by any national securities exchange, or national securities association, or any federal,state, or territorial agency with jurisdiction over securities or variable life insurance;

   c. any judgement or injunction entered against him on the basis of conduct deemed to have involved fraud, deceit, misrepresentation, or violation of any insurance or securities law or regulation.

3. Refusal to Qualify Agent to Sell Variable Life Insurance. Suspension, Revocation, or Nonrenewal of Qualification: The Commissioner may reject any application or suspend or revoke or refuse to renew any agent's qualification under this Article to sell or offer to sell variable life insurance upon any ground that would bar such applicant or such agent from being licensed to sell other life insurance contracts in this state. The rules governing any proceeding relating to the suspension or revocation of an agent's license shall also govern any proceeding for suspension or revocation of an agent's qualification to sell or offer to sell variable life insurance.

ARTICLE XI: SEPARABILITY ARTICLE

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

AMENDATORY NOTES TO THE TECHNICAL CHANGES IN THE NAIC MODEL VARIABLE LIFE INSURANCE REGULATION

Article II

Section 7 - Adds language which recognizes that the separate accounts for non domestic insurers can be "established" pursuant to the statute of the foreign state which corresponds to the legislative framework of the domestic state.

Section 11 - Deletes following the words "rate of investment return" the words "actually credited to a variable life insurance policy" in order to avoid the unintended connotation of proportionate ownership as well as to remove the circularity of this definition when compared to Article IV, Section 2f.

- Adds language indicating that more than one net investment return may exist within a separate account.

Section 13 and Section 16 - See amendatory note to Article II, Section 7.

Article III

Section 2 c - Changes the word "company" in the second line to read "insurer" for purposes of consistency with the remainder of the Model Regulation.

Section 3 - Makes punctuation and minor language changes in order to avoid the unintended interpretation that former subsection b relating to lapse rate tests must actually form part of the insurer's adopted standards of suitability. It was intended only that the test be applied , "by the Commissioner" and not that it be adopted by the insurer.

Article IV

Section 1 - Amends this section to require filing and approval of only those documents which "relate to the variable nature of the policy" and have not otherwise been previously approved in the insurer's fixed benefit operations. Of course, all applicable filing and approval requirements still apply to all documents to be attached to the policy which do not "relate to the variable nature of the policy." Such as for example, changes of beneficiary designation, etc.

Section 1 c - Adds an exemption for pension plans from Article IV, Section 3e(1) and renumbers the exemption from former Section 3q to present 3p. The exemption from 3e(1) is made since the contractual provision required by that paragraph that, except for Article IV, Section 5c(6), only variable life insurance benefits may be funded from the separate account, may be untrue in the case of policies exempt from 3p (former 3q). The description of exempted plans is amended to properly describe the types of plans intended to be exempted. The exemption of Section 3(c)(11) is for separate accounts and not for policies, and the amendatory language reflects this fact.

Section 2 c - Substitutes the words "shall be" for "is" in the first sentence for purposes of consistency. More importantly the condition that "premiums are paid when due" is amended to provide that "premiums are duly paid" in order to include, for example, proper reinstatements.

Section 2 d - Changes "paid when due" to "duly paid" for purposes of consistency.

Section 2 e(1) - The requirement of "fixed benefit" term insurance amounts is deleted for technical reasons.

This section appeared as previously drafted to require that any fully paid-up term insurance be "fixed benefit" rather than variable. A number of unintended consequences would have resulted from this requirement.

For example, Article IV, Section 3 (e)(1) requires that the reserve for fixed benefit coverage be transferred to the general account, thus removing it from the benefit base. If the amount of term insurance were positive, the reserve would be unavailable for the calculation of subsequent term or whole life additions. If the amount were negative, the transfer of assets would have to be from the general account to the separate account in order to avoid a deficiency in the benefit base. This would appear to require the general account to hold a negative reserve to provide a negative death benefit.

In addition, it was not clear whether such fixed benefit term amounts could be taken into account in determining whether the variable death benefit exceeds the minimum death benefit required by Article IV, Section 2 (c). Also, cash values associated with such term insurance amounts might not have been available under the policy loan provisions of policies issued by mutual companies, since Article IV, Section 4 (b)(12) requires that the amounts loaned be withdrawn from the separate account.

The other amendment to this section limits term insurance to annual periods of not less than one year nor more than five. The restriction to annual periods is to provide some degree of uniformity since for example the same "amount" of excess investment performance obviously would "buy" more "one-month" term insurance than "nine-month term insurance." This uniformity may be important in policy comparison. The one year limitation is intended to prevent non fixed term insurance amounts from fluctuating too much. Early drafts of the Model Regulation limited term insurance to one year term "amounts." Research into the minutes of the (C4) Subcommittee indicate that its eventual omission was an uncorrected scriviner's error. The five year maximum limitation is imposed for reasons of uniformity. However, because of competitive benefit illustrations it is doubtful that terms in excess of one year will be utilized.

Section 2j - This section is not new, but rather has been moved from former Article IV, Section 3f. Section 3 in general sets out requirements as to the content of a variable life insurance policy. Former Subsection f thereof, however, stated in detail requirements for the calculation of minimum cash values if the premium rates exceed amounts shown in a table, adjusted for the plan of insurance actually being sold. As written, it would have been necessary to include this entire procedure and table of unadjusted limiting premiums in the policy form. This would have been appropriate.

Section 2k - This new subsection crystallizes the combined effect of Article II, Section 11 and Article VI, Section 2 and 7a into a specific rule. It is important to do so since Article VI, Section 7a deals with deductions of "amounts." The translation of this "amount into a rates is necessary in order to enable determination of a net investment rate which in turn determines benefits under the policy and this is what is ultimately significant to the policyholder.

Section 3a(3) - Changes "paid when due" to "duly paid" for purposes of consistency.

Section 3c(1) - Changes drafting note 8 to reflect potential differences between maximum permitted loan and reinstatement interest rates.

Former Section 3(f) - This section is moved to new Article IV, Section 2j. See amendatory note to Article IV, Section 2j.

Section 3f - This section is renumbered from former Section 3g. In addition the lead paragraph has been amended to make it consistent with the lead paragraph of Section 3. Paragraphs (4) and (5) contain minor grammatical changes for purposes of consistency.

Section 3g - Renumbers former Section 3h.

Section 3h - Renumbers former Section 3i.

Section 3i - Renumbers former Section 3j.

Section 3j - Renumbers former Section 3k.

Section 3k - Renumbers former Section 3l.

Section 3l - Renumbers former Section 3m and in addition a grammatical amendment is made.

Section 3m - Renumbers former Section 3n.

Section 3n - Renumbers former Section 3o.

Section 3o - Renumbers former Section 3p.

Section 3p - Renumbers former Section 3q and inserts the word "which" in order to provide consistancy with the remainder of Section 3.

Section 3q - Renumbers former Section 3r.

Section 3r - Renumbers former Section 3s.

Section 3s - Renumbers former Section 3t.

Section 3t - Renumbers former Section 3u.

Section 4b(4) - This section is amended to correct a possible technical ambiguity since as previously drafted it might not have adequately covered policies which were not in a premium paying status. If the policy should lapse and be continued under a nonforfeiture benefit, the appropriate proceeds payable on death would no longer be "The greater of the minimum death benefit or the variable death benefit, less the indebtedness outstanding." If a policy had been placed on reduced variable paid-up insurance and a policy loan were subsequently made, the reference to the minimum death benefit would be incorrect. If the policy had been placed on a reduced fixed benefit paid-up insurance and a policy loan were subsequently made, neither the minimum death benefit nor the variable death benefit would be applicable.

Thus, this section was intended to provide that "indebtedness shall be deducted from the proceeds payable on death."

Section 5a - Deletes the "two" year suicide exclusion and inserts a "________" since this provision should be consistent with the applicable law in each state.

Section 5c(6) - Is amended to properly reflect the fact that "separate accounts," and not "policies" are exempted pursuant to Section 3(c)(11) of the Investment Company Act of 1940.

Article VI

Section 1f - This section is shortened and amended to properly reflect the fact that "separate accounts" and not "policies" are exempted pursuant to Section 3(c)(11) of the Investment Company Act of 1940.

Section 1g - Is amended for purposes of consistency.

Section 2b - This section is amended to assure no confusion that the calculation as required by this section to apply to the "variable portion" of the policy, as well as to specifically delineate the adjustments necessary in calculating the minimum benefit base for all policies. Reference to the "initial face amount" was deleted since it would not be relevant to a reduced variable paid-up nonforfeiture option.

Section 6b(5) - Is amended primarily to recognize the difference in equitable conversion rights which should be applicable to those policies which are in a premium paying status and those which are paid-up. Thus, new Subparagraph (A) applies to policies on a premium paying basis.

New Subparagraph (A)(i) is modified by inserting "substantially comparable" to conform with the language in new (A)(ii) as well as to recognize the impropriety of conversions to substantially dissimilar plans of insurance. An example of this would be conversion from whole life insurance to five year endowment.

The language deleted at the end of new Subparagraph (A)(i) is reinserted, with some modifications relating to indebtedness, following new Subparagraph (b). In addition, minor grammatical changes are made.

The language deleted at the beginning of former Subparagraph (b) is reinserted in new (aa) of new (ii) since under new (bb) there is no surrender involved in obtaining a paid-up policy and this situation is described in the amendment to new (bb) (former (ii)).

New Subparagraph (b) is new and applies to paid-up policies. It recognizes that as originally drafted, a policyholder could have converted from a reduced paid-up policy to one on a premium paying basis. In many circumstances this would be equivalent to an automatic reinstatement without evidence of insurability.

The language following new Subparagraph (B) restates the material deleted in new (A)(i) and, just as in that section, applies cash value adjustments in the same situations where they previously applied as well as to the situations covered under new (B). Language is added, however, which recognizes the previously unstated need to transfer indebtedness outstanding under the variable life insurance policy to any new policy.

Thus, under (A)(i) just as previously, the conversion would be to a fixed benefit policy as of the original issue age with appropriate cash value adjustments. Under (A)(ii)(aa) there would be conversion to an attained age fixed benefit policy for the amount at risk with a refund of cash values under the variable policy. The new policy would be premium paying and follow the normal nonforfeiture benefit scale appropriate thereto. Under (A)(ii)(bb) there would be a new attained age policy in a premium paying status and a continuation of the old policy under a nonforfeiture option in a paid-up status so that the combined death benefit and cash value would not be changed from that which existed under the variable policy before conversion. No cash value adjustment would be relevant. Under (B) policies in a paid-up status would convert to a substantially comparable fixed benefit policy in a paid-up status with proper adjustments of cash values.

Section 7a(3) - Is amended to specifically recognize the need to release the benefit base at all times when separate account liabilities are released (e.g. conversion to fixed nonforfeiture options) rather than solely on the "termination or partial surrender of the variable life insurance policy."

Section 7a(5) - Adds language consistent with Section 7a(4) delineating the amount on which the percentage charge permitted by this section is to be based.

Section 7a(6) - Is added to specifically recognize the Subcommittee's intention that amounts in excess of separate account liabilities (i.e. seed money can properly be removed from the separate account. (See e.g. Article IV, Section 3e(2).)

Section 9c(3) - Inserts language accidentally omitted through a typographical error.

Section 10b - Changes "insurance company" to "insurer" for purposes of consistency.

Article VII

Section 1 - Adds language specifically requiring notification to an applicant of the provisions of Article IV, Section 3a(5) ("free look") and Article IV, Section 3f (18 month conversion right).

To: Hon. James M. Jackson, Nebraska Insurance Department

From: Michael W. Kessler, Counsel, NAIC Executive Secretary's Office

Re: Commentary on the NAIC's Variable Life Insurance Model Regulation (as amended)

Date: November 14, 1974

In December, 1973, the (C4) Subcommittee charged me with the responsibility of developing an initial draft of a "comprehensive summary of historical comments, notes and other explanatory material relating to the deliberations made in formulating the (NAIC) variable life insurance model regulation."

Ideally, it would have been advantageous to produce such an account during the development of the model regulation. However, as you are aware, various factors made this impossible. Continuous variable life insurance assignments as well as variable life insurance developments at the SEC have precluded comprehensive work on this project until the fall of 1974.

Events outside the Subcommittee's control have made completion of this project all the more important. Personnel changes both on the (C4) Subcommittee and within the insurance departments represented thereon, have resulted in a severe shortage of current (C4) Subcommittee members who actually participated in the development of the model regulation. Therefore, you, those few remaining subcommittee participants, and I represent the only continuity with the development of the model regulation.

For that reason this draft has been approached on the basis which might not have been necessary had greater continuity existed. I have approached these comments on a section by section basis while attempting complete cross-references. I have attempted to concentrate not only on the historical development of the various sections of the model regulation, but have also tried to answer why the subcommittee felt it necessary to act in certain areas.

I tried to note why decisions were made and what envisioned problems were intended to be resolved by these decisions. In this context the drafting comments were intended not only to be interpretive guides but also to constitute a "primer" on the regulatory aspects of variable life insurance operations. I have taken this route in an attempt to provide a single source where those who must regulate under this measure may have reference to the thoughts underlying the model regulation.

The single major function of these comments, however, is to clear up those areas in which the intentions of the Subcommittee may be ambiguous to those who were not parties to the initial deliberations.

In this manner it is hoped that those who must rely on the model regulations will have ready access to a complete source document which explains the regulation.

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VLI Commentary: Distribution Table

(The commentary as adopted in Mexico City refers to the model regulation as it was before technical amendments were made to it in Mexico City. As a result, many references in the commentary to the regulation are incorrect. This will be corrected when the regulation and commentary are integrated following the 1975 Annual Meeting in Seattle. For the present, a list of the changes required is attached.)

Art. III	Sec. 3a	becomes	Art. III	Sec. 3
Art. III	Sec. 3b	becomes	Art. III	Sec. 3
Art. IV	Sec. 3f	becomes	Art. IV	Sec. 2j
Art. IV	Sec. 2k	is new		
Art. IV	Sec. 3g	becomes	Art. IV	Sec. 3f
Art. IV	Sec. 3h	becomes	Art. IV	Sec. 3g
Art. IV	Sec. 3i	becomes	Art. IV	Sec. 3h
Art. IV	Sec. 3j	becomes	Art. IV	Sec. 3i
Art. IV	Sec. 3k	becomes	Art. IV	Sec. 3j
Art. IV	Sec. 3l	becomes	Art. IV	Sec. 3k
Art. IV	Sec. 3m	becomes	Art. IV	Sec. 3l
Art. IV	Sec. 3n	becomes	Art. IV	Sec. 3m
Art. IV	Sec. 3o	becomes	Art. IV	Sec. 3n
Art. IV	Sec. 3p	becomes	Art. IV	Sec. 3o
Art. IV	Sec. 3q	becomes	Art. IV	Sec. 3p
Art. IV	Sec. 3r	becomes	Art. IV	Sec. 3q
Art. IV	Sec. 3s	becomes	Art. IV	Sec. 3r
Art. IV	Sec. 3t	becomes	Art. IV	Sec. 3s
Art. IV	Sec. 3u	becomes	Art. IV	Sec. 3t

COMMENTARY TO THE NAIC MODEL VARIABLE LIFE INSURANCE REGULATION

ARTICLE I. AUTHORITY

SOURCE: NAIC Model Variable Contract Regulation (2 NAIC Proceedings 1968 777 as amended 1 Id 354 (1970), 1 Id 607 (1972).

COMMENT: This Regulation unlike the NAIC Model Variable Contracts Regulation does not contain provisions for notice and hearing. Thus whatever applicable state law or regulation may require in this area will of course govern. As mentioned in the drafting note to this Article, a reference to the rule making authority of the Commissioner and/or references in addition to the Model Variable Contracts Law as amended may be desirable. These might include the Unfair Trade Practices Act.

ARTICLE II: DEFINITIONS

Section 1 – Affiliate

SOURCE: NAIC Model Holding Company Act Section 1a, 2 NAIC Proceedings 739 (1969).

COMMENT: The circumstances in which a "person" becomes an "affiliate" must remain flexible, and depend on the particular facts of each case. However, a person would presumptively be affiliated if: (1) more than 10% of the voting securities were owned; (2) they furnished regular investment advice; (3) they were in "control" of, were "controlled" by, or were in common control with; or (4) were a director, employee, officer, partner of such person or a member of the immediate family thereof. It should be noted that a separate account is not a severable legal entity but rather is an integral part of the insurer. Therefore, it cannot be an affiliate of anyone.

The definition of affiliate contains no percentage limitation. Therefore the definition of "control" (Article II, Section 6) takes on added significance.

The definition of "affiliate" has been expanded from the NAIC Model Holding Company Act to include those "persons" (investment advisers, directors, partners, employees, and relatives) who might obtain personal or corporate gain at the expense of variable life insurance policyholders. A finding of affiliation is significant because it: (1) triggers the conflict of interest provisions (Article VI, Section 7), (2) imposes minimum standards of conduct (Article VI, Section 8), and (3) subjects the entire corporate structures of insurers to scrutiny by the Commissioner relating to its variable life insurance operations. (See Article III, Section 1c(3)(A) concerning those who would otherwise be "non-affiliated persons.")

The inherent close interrelationship of the insurer's general account and separate account, the nature of the insurer's obligation, and the ownership of separate account assets would have made application of the "interested person" concept (see 15 USC 80a-2(19) and 15 USC 80a-10(a)) not only inappropriate, but contradictory to the nature of variable life insurance. Because of the nature of an insurer's variable life insurance operations, the Subcommittee found no beneficial effect in requiring a separate account to have a management which was independent of the insurer. As a matter of fact, they expressly held the insurer's board "responsible" in a management context for all "acts" of the insurer involving its separate account. The Variable Life Insurance Subcommittee expected however that separate account operations would be carefully scrutinized. (See e.g. Article II, Section 9.)

Otherwise independent investment advisers who furnish "regular" investment advice are incorporated within the definition of affiliate in order to preclude any possibility of pyramiding of maximum charges against the separate account to the benefit of the adviser and to the detriment of policyholders, (see also Article VI, Section 7b) as well as to place protection against "overreaching" in general, and potential conflicts of interest within the scope of the regulation.

The definition purposely limits its application to those otherwise independent advisers who regularly furnish investment advice for which a "specific" fee is charged. This is done in order to avoid the possible construction that a broker who as part of his normal brokerage commission gives incidental investment advice would be an affiliate. (See however Article VI, Section 9c(3).)

Section 2 – Agent

SOURCE: NAIC Model Variable Contract Regulation Article II, Section 2, 2b NAIC Proceedings 1970, p. 1885.

COMMENT: See NAIC Agents and Brokers Licensing Model Bill Section 4a(2)(a)1 as amended by the NAIC in December 1973 consistent with the recommendation contained in 2 NAIC Proceedings 1974 p. 383 N. 1.

Section 3 – Assumed Investment Rate

SOURCE: New

COMMENT: This is the hypothetical rate of investment return, after the enumerated "deductions," specified by the insurer in defining the plan of insurance benefits. In a variable whole life policy, for example, it is the rate of investment return at which the variable death benefit (Article II, Section 15) will at all times equals the initial death benefit. It is the rate of investment return used in the calculation of the valuation net premiums. It is also the rate subtracted from the "net investment return" (Article II, Section 11) to determine the excess (positive or negative) which is applied in determining the policy's variable benefit levels. (See Article IV, Section 2e.) It is the rate of investment return at which nonforfeiture benefits must be tested for conformity with those required by the Standard Nonforfeiture Law. (See Article IV, Section 2h.)

A low assumed investment rate will increase the net premium while simultaneously increasing the likelihood that the net investment return will exceed the assumed investment rate. That is, for a given net premium, a low assumed investment rate would produce a lower initial face amount, but a greater probability that subsequent variable death benefits would increase. Thus there may be sound actuarial and marketing reasons for a lower than average assumed investment rate. However, too low an assumed investment rate would make premiums uncompetitively high and possibly run them afoul of the multiples (Article IV, Section 2d) as well as the premium rate tables (Article IV, Section 3f).

On the other hand, a high assumed investment rate would produce a higher initial face amount, but with a greatly reduced chance of subsequent increases in the death benefit. In addition, it should be noted that the higher the assumed investment rate, the more costly the initial face value guarantees will become to the insurer. The Subcommittee was concerned with the possibility that excessive assumed investment rates could be deceptive in suggesting unrealistic policyholder expectations, and could impact adversely on the insurer's solvency. The fourth sentence of Article IV, Section 2h, was included to prevent this.

Section 4 – Benefit Base

SOURCE: New

COMMENT: The benefit base is the "amount," determined in accordance with the policy provisions, to which the difference between the assumed investment rate and the net investment return is applied to determine the extent to which policy benefits vary. (See Article IV, Section 2e; and Article VI, Section 2.) In some of the early drafts of the model regulation, the Subcommittee utilized the term "attributed fund." The term "benefit base" was substituted therefor as more descriptive and to specifically avoid the unintended connotation of individual policyholder proportionate ownership of identifiable assets being read by some into the term "attributed fund." There was no intention by the Subcommittee to change the nature, function, purpose, redeemability, or ownership of variable life insurance reserves from that traditionally applied to fixed benefit life insurance.

Policy design, of course, defines the benefit base as well as the application of the actuarial formula for calculating changes in benefits in accordance with Article IV, Section 2e. However, even for a given policy design the change in benefits will vary in accordance with not only investment performance, but also with the plan of insurance, issue age, policy duration, and in some cases additional factors such as sex.

At any given time the aggregate benefit base for all policies can only be estimated and this aggregate will normally not equal the value of separate account assets. Because individual variable life insurance policy benefits are determined in accordance with the terms of the policy and not by allocation of a proportionate share of the total separate account net investment income, this inability to determine the exact aggregate benefit base has absolutely no impact on the benefits to any policyholder.

Section 5 – Commissioner

SOURCE: NAIC Model HMO Bill Section 2(1) 1 NAIC Proceedings 1973 p. 205.

COMMENT: None

Section 6 – Control

SOURCE: NAIC Model Holding Company Act Section 1(c) 2 NAIC Proceedings 1969, p. 739.

COMMENT: This section closely parallels its source, but the percentage of ownership before "control" would be presumed was slightly amended from "ten (10) percent" to "more than ten (10) percent." This was done to eliminate an internal inconsistency with Article VI, Section 4 which allows ownership of up to 10% of the securities of any one issuer in funding the variable life insurance separate account.

The term "control" (and therefore "affiliate") is defined in terms of the ability to direct or cause the direction of the management of another person, whether or not through stock ownership. Thus, control can in fact be found regardless of the absence of a presumption of "control." The criteria for making such a finding are clearly contained within the definition, to wit: the ability to direct management.

There is no reverse presumption of a lack of control when 10% or less is owned. Rather, the burden would still always be on the person claiming no control to demonstrate this to the Commissioner.

The facts of each particular case in determining control must be judged on their own merits. It is for this reason that the model regulation attempts to preserve maximum flexibility for the Commissioner in order not to bind him in the future to decisions which lack relevance to the actual facts of a particular case. Nonetheless, it would seem that the percentage of stock ownership in question, as well as the existence or nonexistence and size of any other organized factions of shareholders, would be relevant inquiries in determining control.

The finding of control would in turn automatically establish an affiliate relationship and trigger the Conflict of Interest (Article VI, Section 9) and Standards of Conduct (Article VI, Section 8) provisions of the regulation notwithstanding the absence of a presumption of control. The last sentence of this section would also allow the Commissioner to determine that control of or by "persons" without voting securities exists in fact.

The question of notice and procedure is designed to be governed by the administrative law and procedure of the particular state in question. In most instances, this would be a question which would be handled by the state of domicile. (See also comment Article III, Section 5.)

Section 7 – General Account

SOURCE: New

COMMENT: The general account of an insurer may not be an account as such but rather consists of all the assets of the insurer which are available to satisfy its overall obligations. The general account does not include any separate account of the insurer. However, to the extent that a particular separate account's "assets" may exceed separate account "liabilities" they are of course available to satisfy obligations of the general account. (See Article IV, Section 3e(2).) For purposes of the definition of general account, "separate accounts" are not limited to variable life insurance separate accounts (as they are in Article II, Section 13) but include variable annuity and any other separate account permitted by law. The reference to separate accounts established pursuant to the laws of promulgating state should be interpreted to include the equivalent authorizing section of the insurer's state of domicile.

Section 8 – Incidental Insurance Benefit

SOURCE: New

COMMENT: This definition is intended to include all those riders and policy benefits, other than the variable death benefit and associated nonforfeiture benefits and the minimum death benefit, which are sold as a part of or in conjunction with the variable life insurance policy. Benefits are within this definition regardless of whether they may also be sold to variable life insurance purchasers as separate policies or whether the premiums are separately stated or determined – so long as the benefit is normally offered in conjunction with or as a part of the sale a form of a permanent or preliminary term life insurance policy. For example disability waiver of premium and guaranteed insurability options are not normally offered as a separate policy but are offered as a part of a permanent fixed benefit policy and would therefore be "incidental insurance benefits" to the variable life insurance policy. Accidental death benefits may be purchased as a separate policy but are also normally sold as a part of a permanent fixed benefit life policy and would also be "incidental insurance benefits" to a variable life policy. Incidental insurance benefits would also include incidental minimum guarantees. (See Article IV, Section 2h.)

Incidental insurance benefits must be fixed and adequate assets offsetting liabilities arising thereunder must be maintained in the insurer's general account. (See Article V, Section 3.)

Section 9 – May

SOURCE: New

COMMENT: None

Section 10 – Minimum Death Benefit

SOURCE: New

COMMENT: The term "guaranteed" minimum death benefit was consistently used by most of the witnesses in their testimony in the Securities and Exchange Commission hearings which culminated in the adoption of Investment Company Act Rule 3c-4 and Investment Advisers Act Rule 202-1. It has become a "term of art." The general use of this term has been shortened to "minimum death benefit" in the model regulation.

The terminology utilized in Rule 3c-4 (b)(2) (as originally proposed by the ALC-LIAA joint petition) is much more descriptive of the nature and significance of the guarantee – though it was too unwieldy to utilize throughout the regulation. Rule 3c-4 describes the "minimum death benefit" as "an initial stated amount of death benefit and guarantees the payment of a death benefit at least equal to such amount." Such a benefit is payable regardless of investment performance provided that premiums have been duly paid.

This description, which must be read into the definition of "minimum death benefit," emphasizes that the amount guaranteed is the initial face amount and that there is nothing minimal about it. Ascribing minimality to this guarantee would be like describing the guarantee payment of any benefits in a fixed benefit policy a guaranteed "minimum death benefit." (See Article IV, Section 2c.) It would be incorrect therefore to ascribe any such implication of minimality to the Subcommittee's shorthand use and perpetuation – for the sole purpose of simplicity – of the commonly used term in this definition. The substantiality of the guarantee must be measured from the viewpoint of the policyholder and not its cost.

Though variable life insurance does not yet have a specific generic definition one of the conditions to Rule 3c-4 is a minimum death benefit guarantee. While this guarantee may be presently crucial for exemption from the Investment Company Act and while the (C4) Subcommittee has determined that such a guarantee is important enough to the public that every variable life insurance policy must contain it, there has been no determination that the inclusion of a minimum death benefit guarantee is essential to the classification of variable life insurance as insurance. The required minimum death benefit guarantee is not what makes this product life insurance. This perhaps technical distinction is revealed in the regulation's definition of variable life insurance. (See Article II, Section 16.)

Reserves underlying the "minimum death benefit" guarantee must be maintained in the general account. (See Article V.)

Section 11 – Net Investment Return

SOURCE: New

COMMENT: This is the amount expressed as rate, and not as a dollar amount, which is obtained after deducting from the gross investment rate of the separate account, all expenses, costs, and other deductions (as a percentage of the assets on which the rate of gross investment return is calculated) which are authorized by this regulation. (See Article VI, Section 7.) (See Comment Article II, Section 3.)

The use of the phrase "applied to the variable life insurance policy" was not intended to imply any proportionate or individual ownership or right to the aggregate assets of the insurer or any right other than the right to receive those benefits for which the policyholder is eligible under the policy. (See Comment Article II, Section 4.)

Section 12 – Person

SOURCE: NAIC Model Holding Company Act Section 1(f) 2 NAIC Proceedings 1969 p. 740.

COMMENT: This section was intended to include all forms of business enterprise no matter what their organization. It includes affiliates and if applicable, governmental entities. An insurer's separate account by itself could not be a person. (See Comment Article II, Section 1.)

Section 13 – Separate Account

SOURCE: New

COMMENT: See comment to Article II, Section 7. The blank space in this section should be completed with the section of the Variable Contract Law authorizing separate accounts. The reference to the law of the promulgating state authorizing the establishment of a separate account should be interpreted as including the equivalent thereof in the insurer's state of domicile.

Section 14 – Shall

SOURCE: New

COMMENT: None

Section 15 – Variable Death Benefit

SOURCE: New

COMMENT: When the net investment return of the separate account (see Article II, Section 11) is greater than the assumed investment rate (or the net investment return minus assumed investment rate is positive) the variable death benefit will reflect the full application of this difference (after the necessary adjustments for policy loans) to the benefit base under the terms and design of the policy, and the variable death benefit payable to the policyholder will to that extent exceed the initial face amount or minimum death benefit. (See Article IV, Section 2f.) Article IV, Section 2e provides that the variable death benefit shall reflect the full net investment experience of the separate account after the authorized deductions.

Conversely, when the net investment return is less than the assumed investment rate the variable death benefit will decrease and depending on past performance may become less than the minimum death benefit. In this situation, of course, assuming premiums have been duly paid, the insurer will be obligated to pay the initial face amount of the policy (minimum death benefit). Thus the insurer is always obligated to pay the greater of the minimum death benefit or the variable death benefit.

The variable death benefit even when it is less than the minimum death benefit is a useful figure to policyholders in conjunction with various hypothetical investment returns as a disclosure device for the purpose of cost and benefit comparison of policies. It can illustrate the level of performance required to return above the minimum death benefit, as well as the receptivity of the variable death benefit to market fluctuations and therefore the significance of the "minimum death benefit guarantee."

Section 16 – Variable Life Insurance Policy

SOURCE: This section is derived from the NAIC Model Variable Contract Regulation Article II, Section 1 2b, NAIC Proceedings 1970, p. 1185.

COMMENT: This definition generally corresponds to the generic description in which benefits fluctuate with the separate account's investment experience. However, this section and consequently this regulation does not by definition cover so-called "index policies" popularized in other countries which link their benefits to an external indicator such as the cost of living index. The regulation does not cover these policies since benefits are not directly related to investment performance. Sale of such policies in the United States has not been successful because of their extremely high cost. The one instance of domestic sales with which the Subcommittee is familiar limited increases to 3% per year. There would be great difficulty in reserving for a policy which did not provide for such a limit.

While variable premium – variable benefit policies are not excluded from this definition they are presently prohibited by Article IV, Section 2b. (See Comment to Article IV, Section 2b.)

The definition does for the present specifically limit variable life insurance to individual policies. A master contract and certificate of enrollment relationship would not be permitted.

The Subcommittee was at one time urged to exclude from the definition of variable life insurance "contracts used to fund qualified retirement plans and . . . contracts under which the amount of the death benefit is less than the minimum multiple of the gross premium shown in . . . (Article IV, Section 2d) of this regulation."

Policies which failed to meet the multiples would not be exempt under SEC Rule 3c-4. Policies used to fund qualified retirement plans would be exempt from the Investment Company Act pursuant to Section 3(c)(11).

This suggestion was specifically rejected. The Subcommittee saw no reason why a different regulatory pattern should be developed by the states for these policies. However, recognizing some different regulatory concerns, the Subcommittee did exempt tax qualified corporate pension and profit sharing and H. R. 10 plans from several provisions. (See Article IV, Section 1c exempting them from Article IV, Sections 2a, 2d, and 3q.)

The blank space in this section should be completed in the same manner as described in the comment to Article II, Section 13.

ARTICLE III: QUALIFICATION OF INSURER TO ISSUE VARIABLE LIFE INSURANCE

Section 1 – Licensing and Approval to do Business in this State

SOURCE: Derived from the original NAIC Model Variable Contracts Regulation

COMMENT: In Subsection a the word "organized" can be read "domiciled." Therefore the insurer must be either an admitted or a domestic life insurer in the state promulgating the regulation.

In addition Subsection b requires that the state of domicile of the insurer must provide for substantially similar regulation of permissible investments and changes in investment policy prior to the receipt of approval by the Commissioner as required by Subsection c of the section.

Changes in investment policy and permissible investments were of concern to the Subcommittee. (See Comments to Article IV, Sections 3, 4, 5, and 6.)

While it is anticipated that there will be a high degree of uniformity in all phases of the model regulation, it was recognized that if there were numerous and possibly conflicting methods of changing investment policy and permissible investments, confusion would exist. Therefore, it was determined that especially in these two areas, uniformity should as a practical matter be achieved among the states adopting the model regulation by means of this subsection while simultaneously providing for input from the regulatory authorities of all states affected.

In variable life insurance, policyholders' benefits exceeding (either positively or negatively) the guaranteed initial face amount are directly related to the investment performance of the separate account. Therefore, permissible investments and any change or failure to change the investment policy upon which the policyholder relied in purchasing the policy are of obvious concern to him and therefore the insurance regulator. Of equal concern to the insurance regulator is the impact of adverse separate account investment policy on the general account and therefore the insurer's fixed benefit policyholders who did not take the same risks or seek the opportunities of variable benefits. Because of the inherent close interrelationship of the separate account with general account and its role as a guarantor of the minimum death (initial face value) benefit the Subcommittee had to assure that investment policy and the method of change thereof would be such that it would reasonably protect the interests of variable as well as fixed benefit policyholders. Furthermore a uniform method of changes in investment policy had to be assured so that policyholders of the same insurer in different states would be treated equally.

The Subcommittee considered a number of approaches to these problems (including variable life insurance policyholder voting rights, conversions to new separate accounts and prohibition of changes in investment policy entirely) before adopting the language contained in Article VI, Section 3 (Investments) and Section 6 (Investment policy). The comments to those sections provide detailed analysis of the rationale behind the approach taken as well as why others were discarded.

Note, however, that this subsection does not even allow another state's regulation to be more stringent if it is not "substantially similar" to the scheme envisioned by the model regulation.

Although not mentioned specifically in this subsection, the Commissioner should also consider the similarity of the regulation of the insurers state of domicile to Article VI, Section 4 (Limitations on Ownership) as it relates to permissible investments in Article VI, Section 3.

The question of when particular investment restrictions would be substantially similar to those permitted in the state of domicile is one which cannot and should not be the subject of a speculative answer based on hypothetical and tentative facts. The model regulation was designed to provide the Commissioner with the maximum administrative flexibility possible in order to protect the public. Thus, the meaning of "substantially similar," as other provisions of the model must await the specific facts of each case.

However, it would seem that if, for example, one of the investments specifically prohibited by Article III, Section 3c (e.g., real estate), were permitted, such restrictions would not be substantially similar.

The determination would have to be made by the Commissioner in each state in which the insurer was seeking to do business, and would of course be governed by that state's administrative laws, regulations, and procedures. It would seem that among the criteria considered should be: (1) The existence of an ascertainable market value; (2) liquidity; (3) proper uniform valuation; (4) consistency with the model; and (5) whether or not the investment was consistent with the life insurance nature of variable life insurance.

Subsection c is new, although Subparagraph (3) is derived from the original Model Variable Contracts Regulation. This Subsection requires the insurer wishing to write variable life insurance to obtain the written approval of the Insurance Commissioner. It also includes the standards that the Commissioner must apply and the considerations which he must apply in making a determination of whether to grant or deny such approval.

As an introduction to this requirement it is instructive to consider generally some of the concerns and approaches taken by the (C4) Subcommittee in developing this portion of the regulation.

The NAIC Model Variable Contract Law requires, in Section 3, that before a company can deliver or issue for delivery in any state a variable life contract, it must satisfy the Commissioner that "its condition or method of operation in connection with the issuance of such contracts will not render its operation hazardous to the public or its policyholders in this state." This requirement has been broken down primarily into the three paragraphs of Subsection c and is not significantly different from the standard presently applied by insurance departments when considering a license application by a new company. However, there are a number of different factors to be considered by the departments before variable life authority should be granted.

> Capital and surplus requirements. All states presently have capital and surplus requirements for admission of foreign life insurers. The Subcommittee found no persuasive reason why higher capital and surplus requirements should be necessary for authority to write variable life insurance so long as the present standards adequately measure the stability of the company. Of course, the insurer, regardless of minimum capital and surplus requirements, must still demonstrate to the Commissioner's satisfaction that its plan of operation is not unsound. (See Article III, Section 1c(1).) The Subcommittee also recommends that each state reexamine its present capital and surplus requirements to assure their adequacy for variable life insurance operations. Until more experience is obtained, it appears advisable that each company either has a minimum earned surplus, or, in the alternative, is willing to submit to close monitoring by the insurance department as to premiums written, investments, and operating costs. To some extent, the earned surplus requirement may discourage entry of new firms into the variable life market. However, the monitoring approach offers an alternative. Any special reporting requirements might be lifted once the department is confident of its regulatory system as it relates to variable life and the condition of a particular company indicates that such a move is responsible.
>
> Repeated violation of insurance laws. There are many insurance laws and department regulations covering life insurance marketing. These laws and regulations to the extent they are applicable and not inconsistent with the model variable life insurance regulation, will, of course, apply to variable life insurance. It can be anticipated that of the regulatory problems with variable life insurance, many will spring from its marketing side. Thus, a company's record in abiding by present life insurance marketing laws is crucial.
>
> Extra seasoning. The Subcommittee considered the desirability of recommending that companies seeking variable life insurance authority be required to have a longer history of operations than a company seeking fixed benefit life authority. However, they found no persuasive reasons to make such a recommendation. Nevertheless, they strongly recommend that company management be closely examined as required by Paragraph (2) and (3), and that the financial stability of the company be closely examined. (See Article III, Section 1c.)
>
> Management qualities. It appears that most life insurers presently contemplating variable life insurance intend to invest the assets of the separate account primarily in common stocks. However, many life insurers have significantly

less experience investing in common stocks than they have with other investments. Therefore, the Subcommittee recommends that each Insurance Department examine the equity investing experience, familiarity, and expertise of the management of insurers requesting authority to write variable life insurance.

The Commissioner is required to make the affirmative findings delineated in Paragraphs (1) - (3) in order to grant approval under Subsection c. If he does make these findings, the regulation requires him to give his approval. However, in order to make the determination required he should carefully consider the material required to be submitted by Article III, Section 2 as well as any other material which he deems relevant to the inquiries presupposed by the required findings of this Section.

In order to grant approval under Paragraph (1) of this Subsection the Commissioner must find that the insurer's plan of operation for the issuance of variable life insurance is "not unsound."

There is no uniform consensus on what constitutes a "plan of operation." A presentation to the Commissioner pursuant to this Section, however, should include a comprehensive examination of the reasonably expected impact of the insurer's proposed variable life insurance operations on the insurer, its policyholders within the state, and the general public. At a minimum it would seem to require a description of expected policy designs, the financial impact (including the impact on surplus), the insurer's proposed standards of suitability, standards of conduct (see Article III, Section 3 and Article VI, Section 8), and methods of operation (i.e. names of service companies, the nature of internal and advisers operation). It was intended that a complete technical description of the benefit base and its operation would be required to be filed as a part of the plan of operation. (See Comment Article IV, Section 2h.) (See also Comment Article V.) Other information including sales projections may also be desirable. Since the need for approval to do business is continuous, this Section implies a continuing obligation for the insurer to notify the Commissioner when and if information which was relied upon in giving approval, changes in any substantial degree. (See also Article VI, Section 10.) This would include key changes in either internal or external personnel.

In Paragraph (1) the meaning of the words "not unsound" was intended to be flexible, and have a much broader interpretation than merely being "actuarially" sound. Rather the term was intended to include a determination that the proposed plan is not fundamentally unfair or inequitable to any class of the insurer's policyholders or the general public. For example a finding of unsoundness could result from a policy's design, benefit structure, possible impact on the insurer as a whole, or any other fact which indicates adverse impact on the public, including actuarial infirmity. This paragraph contemplates a review of whether or not the plan is fundamentally fair and equitable to the public. An example of such unsoundness might be a policy design so inherently deceptive, unfair or confusing that even proper disclosure would not be likely to result in understanding by a prospective purchaser as to what he is buying.

During the course of its deliberations in developing the model regulations the Subcommittee was confronted with a number of proposed provisions and policy designs which might be placed in this category. This experience underlay the Subcommittee's determination to severely limit policy design for the present. This intention should not, however, be interpreted to mean the Subcommittee would not be receptive to some flexibility and innovation in the healthy future development of variable life insurance policy design.

Reference to the Unfair Trade Practices Act might be helpful in interpreting the term unsound in this context.

An example of a plan of operation which would in the opinion of the Subcommittee be clearly unsound in both the actuarial and fairness senses would be one which included the application of policyholder voting rights for changes in separate account investment policy. The method chosen to deal with this problem is discussed in the comments to Article VI, Section 6, however, the Subcommittee specifically rejected policyholder voting. (See Comment Article VI, Section 6.)

A separate account is basically an accounting mechanism to measure the level of benefits the insurer owes to its variable life insurance policyholders. All assets of the insurer, not just those underlying the separate account, stand behind the insurer's total obligation including assumption, mortality, and expense risks and the guaranteed minimum death benefit. Consequently, state insurance regulators have the responsibility to examine closely the investment practices and management of the entire insurer and, where necessary, step in to protect the policyholders.

Voting rights over changes in investment policy can have no application to a life insurance company which has undertaken a contractual obligation to pay a death benefit. Requiring the insurer to turn over its separate account assets to a manager chosen by the purchasers of variable life insurance while the company's general assets are still at risk would conflict with insurance regulator's responsibility to all policyholders of the insurer. In short, an insurance regulator cannot permit one group of policyholders to be the ultimate arbiter of investment policies that can have a profound impact on other policyholders as well as upon the financial integrity of the company as a whole.

Paragraph (1) could be utilized to require an insurer to participate in a guaranty fund to the extent of risks not assumed by the policyholders. It should be noted in this context that adverse investment performance which may result in reductions in nonforfeiture benefits and the variable death benefit to the extent it exceeds the minimum death benefit, are the only risks assumed by policyholders. (See Comment Article IV, Section 2a.)

Paragraph (2) requires the Commissioner to examine the character, and in general, the qualifications of the management of both the insurer and those various organizations which are proposed to handle significant aspects of the insurer's methods of operation on a contractual basis. Though the insurer and its board of directors are ultimately responsible for all activities of the separate account and the insurer (see Article VI, Section 9a), the Commissioner must be reasonably satisfied as to the ability of the persons involved to carry out the obligations of the insurer to the public in general.

Paragraph (3) with the exception of Subparagraph (D) is an expansion of portions of the original Model Variable Contracts Regulation. Thus in addition to making the findings required by Paragraphs (1) and (2), the Commissioner must, after considering the information delineated by Subparagraphs (A) through (D) inclusive, be satisfied that the present and prospective financial condition of the insurer and method of operation will not be hazardous to the public.

The inquiry of Paragraph (3) is basically one of financial soundness and the ability to satisfy all the obligations imposed on the insurer by variable life insurance operations. For example one alternative requirement of Article V, requires under certain circumstances reserves which anticipate an immediate 1/3 drop in the value of separate account assets. In order to satisfy the requirements of this section the insurer must demonstrate that in a period of sharply declining values it has the surplus needed to meet these obligations without jeopardizing the public or any class of its policyholders.

Thus the term "policyholders" means all policyholders of the "insurer" and not just variable life insurance policyholders.

Subparagraph (A) is self-explanatory and relates to the previous discussion concerning seasoning, chronic insurance law violation, capital and surplus requirements and the willingness of the insurer to be subjected to close Insurance Department monitoring.

While Subparagraph (3)(B) may appear to be repeat requirements contained in Paragraph c(1) of this section it should be noted that while c(1) is itself a required finding of the Commissioner, (3)(B) is only one factor which must be considered in determining the prospective financial condition of insurer. Of course this Subparagraph refers to both internal and external investment advisers and the previous discussion relating to the relative equity investment expertise of insurers is clearly a consideration which should be made in this context. (See also Comment to Article VI, Section 1a relating to custody.)

Under Subparagraph (c) the insurer must be able to demonstrate that the laws and regulations of its state of domicile are such as to protect the financial interests of the policyholders in the promulgating state. It should be noted that two areas were so significant that the regulation specifically requires that the regulation of the insurers domicile be "substantially similar" to the model regulation. (See Article III, Section 1b.) However, this does not imply that the insurer seeking to do business in a state is under any less of an obligation to convince the Commissioner that the entire regulatory scheme (not just the two areas enumerated) of the insurers domicile is not likely to be hazardous to the admitting state's policyholders.

Thus as the NAIC has stated, this Subparagraph "require(s) a state to satisfy itself that the regulation of those areas (e.g., separate account operations) which will primarily be controlled by the state of domicile, is consistent with laws and regulations in the state in which the insurer is proposing to do business."

In this manner the Subcommittee sought to assure adequate protection of all policyholders as well as to promote uniformity.

Subparagraph (D) is new and obligates the Commissioner to examine thepossible effect of any affiliation by the insurer on the prospective financial condition of the insurer and the effect on the policyholders.

As previously discussed this aspect relates to management experience, the ability of the insurer to meet its obligations and the favorable or unfavorable experience which the insurance department has had with the insurer's corporate family in supervising compliance with applicable insurance laws and regulations. This section may also be useful in determining potential conflicts of interest.

It should be noted that early drafts of the regulation included the following provision instead of this Subparagraph:

> If the company is a subsidiary of an admitted life insurance company, or affiliated with such company by common management or ownership, it may be deemed by the Commissioner to have satisfied the provisions of Paragraph 1(b) (now Article III, Section 1c(3)) if either it or such admitted life company satisfies that paragraph. Companies licensed and having a satisfactory record of doing business in this State for a period of at least three years may be deemed to have satisfied the Commissioner with respect to Paragraph 1(b).

The concept inherent in this former provision that mere affiliation with a previously admitted insurer would satisfy the financial condition requirements for approval to commence variable life insurance operations was obviously specifically rejected by the Subcommittee. However, it is a factor which can properly be considered.

Section 2 – Filing for Approval to do Business in this State

SOURCE: Portions of this section are derived from the original NAIC Model Variable Contracts Regulation. (See 2 NAIC Proceedings 1968.)

COMMENT: In order to provide detailed information sufficient to enable the Commissioner to make the findings required by Article III, Section 1c this section requires the filing of certain information by the insurer. It is also useful in making determinations pursuant to Article III, Section 1b. The data described by all of the subsections must be provided prior to the granting of approval under Article III, Section 1c, except for Subsections e and f which must be provided only if they have been requested by the Commissioner. The Subcommittee fully expected that all Commissioners would request this data in order to make the required findings of Article III, Sections 1b and c(2) and c(3)(B) and (C).

Subsection a relates to the findings under Article III, Section 1c(1) and (3), as well as Article IV, Section 1.

Subsection b relates to Article III, Section 1c(1)(2) and (+)(B) and (D) as well as Article III, Section 5 and Article VI, Section 1 and 10.

Subsection c relates to Article III, Section 1b, 1c, and Article VI, Section 6. A statement pursuant to this Subsection would include specific descriptions of the investment goals of the separate account (e.g. long term growth), the means by which these goals are to be met (e.g. primarily common stocks) and any internal investment restrictions. (See Article VII, Section 2.)

Subsection d goes hand in hand with Subsection c and relates to Article III, Section 1b and 1c.

Naturally Section 2 as well as Article III, Section 6 were not intended to be exclusive and these sections do not prohibit the Commissioner from requiring additional relevant information which may be required for him to make determinations required by this regulation as well as other applicable laws and regulations.

Section 2 implies a continuing obligation to amend as necessary any report made to the Commissioner pursuant thereto when the circumstances underlying the original report have changed.

Section 3 – Standards of Suitability

SOURCE: Portions of this Section are derived from the NAIC Model Regulation on Deceptive Practices Section 5(f) (sic (g)?) 2 NAIC Proceedings 1973 p. 542, SEC Rule 15b 10-3, and the holding in Anderson v. Knox 297 F. 2d. 702 (9th Cir., 1961), cert. den. 370 U. S. 915 (1961). Subsection b is new.

COMMENT: This Section imposes a duty on both the insurer and its agents to make a good faith reasonable inquiry as to the facts or circumstances concerning a prospect's insurance and financial needs and to make no recommendation to purchase variable life when such a purchase is not reasonably consistent with the information which is known or reasonably should be known to the insurer or agent. Some of the factors which would presumably be considered are: age, earnings, marital status, number and age of dependents, the value of savings and other assets, and current life insurance program. A major inquiry would be whether or not a prospect were considering the purchase of a variable life insurance policy as an investment. (See Comments to Article III, Section 4; Article VII, Section 9; and Article VIII, Section 3; as well as Appendix A.)

The duty to make a good faith reasonable inquiry must be stressed since an insurer or agent cannot continually seek to avoid the obligations imposed by this Section by claiming that a prospect refused to divulge information sufficient to make a professional evaluation of the suitability of variable life insurance to particular circumstances.

At its June 1974 Meeting the NAIC adopted a staff report which details the implications of Subsection a (2 NAIC Proceedings 1974 540). This report explores the three basic areas of ideal suitability as (1) needs perceived by the insurer, (2) needs perceived by the agent and, (3) persistency, and contains interpretative rules. It was adopted as an interpretative guide to this section and is therefore included as Appendix A.

This Section requires the insurer to formally adopt and file with the Commissioner (See Comment Article III, Section 6d) its suitability standards which are applicable and binding on the insurer and its officers, directors, employees, affiliates, and agents. Earlier drafts of this section specifically required that the insurer establish and file with the Commissioner guidelines or profiles of applicants and situations in which variable life insurance would not generally be suitable. While this specific requirement has been deleted, the Subcommittee clearly presumed that in order to be in good faith compliance with obligations imposed by this Section, insurers would adopt either formal or informal suitability underwriting guidelines. Insurers which utilized a sales or marketing contractual service would clearly not be relieved of their obligations under this section. (See Article III, Section 5.)

As to the potential legal implications of adopting standards of suitability, it is not unlikely in those jurisdictions where the doctrine of implied rights of action is accepted, that such theory would give rise to an enforceable obligation to the insured. (See e.g. Anderson v. Knox 297 F. 2d. 702 (9th Cir., 1961).) Furthermore, it is probable that the Commissioner would have the authority (either formal or informal) to reverse an "unsuitable" sale upon the request of the policyholder. This would be in addition to the full range of sanctions available to him.

It was the intention of the Subcommittee that the requirements of this Subsection would not be applicable with respect to each individual employee involved in a noncontributory pension plan situation.

The original draft of suitability provisions required that the insurer file its general suitability guidelines with the Commissioner. After making inquiry of the prospect the insurer was obligated to measure the guidelines against characteristics of each applicant to determine general suitability. Upon making that determination, the insurer was compelled to inform a prospect whether guidelines indicated general suitability and obtain a receipt for such notification. Once he had been so notified the prospect would have been free to purchase variable life insurance if he so desired even if the guidelines indicated probable unsuitability. This approach was altered to accommodate potential problems which may arise from the present dual regulation of variable life insurance. (See 1 NAIC Proceedings 1974 p. 490.)

Subsection b is new and provides a method for the Commissioner to partially determine whether or not the insurer is in reasonable compliance with the obligations of good faith imposed by this Section.

The position of the Subcommittee is clearly that high early lapse rates are largely a function of oversales and/or missales to persons who don't really want and/or should not buy variable life insurance. Conversely, suitability is related to favorable persistancy. (See Appendix A.) Obviously, suitability is a difficult area to police. Therefore, the lapse rate tests were incorporated in this section.

Early drafts related this test solely to lapse rates which were significantly higher than the insurers fixed benefit lapse rates. This circumstance was to be prime facie evidence both that the insurer's "guidelines" were improperly drawn and that the insurer was engaging in unsuitable sales as a general business practice. This was amended in the manner reflected in the model since it was possible that the inherent nature of the product itself, and/or the requirements of the regulation could be a cause of lapse rates higher than fixed benefit life insurance.

Of course, any discussion of policy lapses must be prefaced with a notation that lapse experience varies widely according to various factors, including policy type, market served, and company. A more detailed discussion of this area is contained in the suitability memorandum hereinbefore discussed.

The model provides that lapse rates significantly higher than both the insurers fixed rates and the industrywide variable life insurance lapse rates, will provide an indication to the Commissioner who will presumably initiate further inquiry as to the cause of such "failure." Naturally failure of only one of these tests would not bar a Commissioner's investigation. Thus if a company experienced lapse rates "significantly higher" than those of its fixed benefit policies, but within the industrywide experience, it would certainly be an indication for the Commissioner to examine the selling practices of the insurer as well as the regulation and nature of the product in order to discover what was causing the discrepancy – since it could be the result of any or all of those factors.

It should be noted that policy conversions pursuant to the requirements of the regulation are not treated as lapses. Certainly, a large number of conversions from variable life insurance to fixed could be the result of unsuitable sales. However, they could also very likely be the result of factors totally unrelated to suitability (e.g., separate account performance, which may be either very favorable or very unfavorable). Thus, such conversions would not be a traditional type lapse and are not treated as such. Furthermore, this conversion right is a privilege which does not exist for other classes of policyholders, but rather is imposed on the insurer as a mandatory variable life insurance policy provision. For these reasons, it was not felt to be fair to force a comparison between two potentially very different situations. Rather, it was felt that they should be considered separately. Such data will be available during the insurer's examination for analysis. This may become increasingly important in light of the increasing tendency of insurance examiners to inquire into the insurer's marketing conduct.

The Subcommittee anticipated that a Commissioner would require periodic statements of lapses and conversions pursuant to Article III, Section 6d and Article III, Section 3b, and eventually perhaps in the annual statement.

While it may be unclear from the text of the regulation Subsection b was not intended to be included as a part of the insurers formal standards of suitability.

It should be noted that Article VIII, Section 3 requires that variable life insurance applications to contain questions designed to elicit suitability information from applicants.

Section 4 – Use of Sales Materials

COMMENT: New

The Subcommittee reviewed the problem of variable life advertising at some length. The regulatory pattern, as it presently stands, actually grants authority to control advertising to both the state insurance departments and the SEC. This factor alone will inherently cause problems. But the situation is further complicated by the different regulatory orientations of these two bodies. The Insurance Departments have a legitimate interest in assuring that prospective purchasers understand that variable life insurance is life insurance. The SEC has claimed jurisdiction on the grounds that variable life insurance is a security and thus will probably seek to have that theory emphasized in any related advertising.

In addition to this difference in orientation, there appears to be some conflict in the views held by these bodies on advertising as a sales tool. In general, Insurance Departments view life insurance as sold by a salesman, not by the advertising material. Thus, a wide range of media advertising techniques are permitted. In addition, of course, the departments regulate the contracts sold with an eye to quality. This results in removal from the market of undesirable contracts or contracts which are inherently bad buys, because the contract is inequitable.

To some extent, securities sold by investment companies are also regulated for quality -- at least to the extent of regulation requiring minimum financial standing, some standard contract provisions, and limitations on sales expenses. However, the emphasis is on informed participation in management by the shareholders. This in turn depends on delivery to the shareholder of information on the company, its operation and the security. This end is accomplished by severely limiting usable advertising and by specifying its content in detail.

The Subcommittee saw no easy way to reconcile these two approaches and hopefully some compromise will eventually be reached. In the immediate future, however, the Subcommittee foresaw considerable confusion in the handling of variable life insurance advertising. Each department must also recognize that it will be dealing with a different life insurance policy which will engender new advertising approaches. In addition, there may be a trend to advertisement of variable life insurance in particular, rather than the institutional advertising which has been typical of life insurers in the past.

For these reasons, the Subcommittee has written into the model regulation a requirement that all variable life insurance advertising and agent training materials be submitted to the Commissioner either prior to use or shortly following use, and that they be disapproved for use if they are false, misleading, or deceptive with respect to policies, or the operation of the separate account. The Subcommittee contemplated this as an interim measure only. Once sufficient knowledge is acquired and the market has stabilized, a return to random checks on compliance with a variable life insurance advertising regulation may be adequate.

It should be noted that the NAIC Insurance Advertising Regulation and Guidelines (B6) Subcommittee has been assigned responsibility for drafting a model regulation for life insurance advertising, including variable life insurance advertising.

Many states presently have in effect regulations directed at abuses in the advertising of fixed benefit life insurance. Generally speaking they are intended to remove from the market advertising designed to confuse life insurance with securities and mislead the purchaser about the true nature of the life insurance policy he is buying. The Subcommittee is strongly in favor of these regulations as they apply to fixed benefit life insurance. However, it is possible that a number of the provisions in these regulations may conflict with the legitimate advertising needs of variable life insurance. For this reason, it is recommended that each state review any life insurance advertising regulations in effect with the intention of revising them, if necessary, so that fair and complete descriptions of variable life insurance may be presented to the public.

Naturally the primary purpose of this Section is to prevent the use of sales materials which will intentionally or unintentionally mislead the public as to what they are getting and how much it is costing them. It is within this context that the determination of what is "false, misleading, deceptive, or inaccurate," must be made.

A specific concern of the Subcommittee in this area is potential sales of variable life insurance in a manner which might falsely portray it as a type of investment. It was clearly the Subcommittee's position that variable life insurance was not an investment and should not be purchased for reasons other than primarily death protection. Therefore, the Subcommittee anticipated very close supervision of sales materials to prevent this occurrence. In this context it is at least conceivable that certain hypothetical rates of return could be inherently misleading. However, there is a built-in conflict in this area between the standard prohibition against projecting past returns and simultaneously giving the prospective policyholder a reasonable expectation of his benefits.

Nothing in this Section was intended to modify the Commissioner's authority to regulate the dissemination of sales materials in his state regardless of where such materials originated.

The inclusion of Drafting Note 5 does not reflect an intention to abandon the standards and protections contained in Article III, Section 4 of the model regulation. This Drafting Note was inserted because it would be a burden on some Insurance Departments to physically store every piece of sales material which would have to be filed. The intent of this Drafting Note was to require an insurer to retain such material on its premises rather than storing them at the Insurance Department. As such, they would be subject to inspection and examination by the Insurance Department and the protections and standards contemplated by this Section could be enforced.

This Section was intended to reach any material which is designed for ultimate presentation to prospective purchasers in attempting to convince him to purchase variable life insurance. As such, it was intended to include agent training materials, prepared sales talks and potential sales approaches which might be tried on a prospect. The reason agent training material was included is based on the Subcommittee's concern over the ultimate presentation to the prospect if the agent were falsely led to believe that the variable life insurance product was, for example, indeed an investment of some type. The term "substantial import" was included so as not to require refiling for changes in things such as dates and minor corrections of typographical errors.

The use of false or misleading sales material could give rise to the full extent of powers at the disposal of the Commissioner. These would range from license revocation (for both the insurer and agents) fines, a cease and desist order, to informal disciplinary sanctions. Furthermore, the activities described would violate the state unfair trade practices acts. In addition, the Commissioner as a practical matter probably possesses the power to rescind a sale based on a material misrepresentation. Common law fraud causes of action, as well as implied rights of action, also may exist depending on the law of each individual state.

Section 5 – Requirements Applicable to Contractual Services

SOURCE: New

COMMENT: This section was added to give the Commissioner control over contracts for material variable life insurance services performed for the insurer by a third party. Since these material operations are functions which would normally be carried on by the insurer itself, and thus would be subject to the Commissioner's direct control, the Subcommittee inserted this Section in order to assure that the same interests of the public and the policyholders would be protected. This Section, therefore, indirectly regulates "service" companies through the regulation of service contracts under which a variable life insurer is to be obligated. Thus, Subsection a requires the contract to be in writing and requires the service company to subject itself to examination and/or furnish the Commissioner with information sufficient for him to determine whether or not the service operations conducted for the insurer are consistent with the relevant portions of both the model regulation and other applicable laws and regulations.

The word "material" was inserted so that functions which were not relevant to the welfare of the policyholders or the public were not required to be covered by this Section. Naturally, the question of materiality must ultimately be answered by the Commissioner. However, the contracts referred to in this Section were not intended to include traditional agency compensation agreements and normal reinsurance treaties.

The Subcommittee fully intended that service company operations should be a significant part of the insurers "plan of operation," (Article IV, Section 1c(1)) and as such that Section implies an obligation to notify the Commissioner of any change therein. The Commissioner was felt to possess the inherent power to terminate a service contract which he felt to be hazardous to the public or the insurer's policyholders.

Subsection b requires the contract to be fair and equitable to all parties. (See Article IV, Section 9.)

Subsection c was inserted to assure no misunderstanding that the use of a service contract did not relieve any obligations of the insurer.

It is impossible to speculate in the absence of actual facts as to what particular circumstances might give rise to "control" of an insurer by a service company. The Subcommittee intended that the Commissioner should have flexibility in making this decision.

The performance of services in the absence of stock ownership, would not by itself seem to constitute "control" since this would not appear to give rise to the ability to direct the management of the insurer. That is, if a service company performed all or substantially all of the administrative functions associated with the variable life insurance contracts, advised the insurer as to regulatory requirements associated with the contracts, managed an investment company in which all or substantially all of the separate account's assets were invested, and reinsured all or substantially all of the risks under the variable contracts, it would not necessarily be in control. However, the furnishing of regular investment advice would give rise to an affiliation between the insurer and the service company pursuant to Article II, Section 1.

Section 6 – Reports to the Commissioner

SOURCE: Portions of this Section are derived from the original Model Variable Contracts Regulation.

This Section was not intended to include all of the material which must be filed or reported to the Commissioner of each state in which the insurer is doing business. Additional individual Sections impose specific requirements. (See e.g. Article III, Section 4; Article IV, Section 1; Article III, Section 3b; Article IV, Section 2h; Article IV, Section 3c.)

Furthermore, as provided in Subsection d, the Commissioner may require such additional information concerning an insurer's variable life insurance operations as he deems necessary.

Subsection a is not intended to imply that a separate account is a severable distinct entity.

Subsection e requires the Commissioner to disapprove the material filed under this Section if he finds it to be materially false, misleading, deceptive, or inaccurate, and further requires distribution of an amended report. Naturally, this distribution would be to those who received the defective report, however, some flexibility was intended for the Commissioner.

The filing of an amended report is not the limit of sanctions which could be imposed on the insurer for defective reports. Rather, the full range of sanctions at the disposal of the Commissioner delineates the potential liability of the insurer. This could include, depending upon the seriousness of the violation involved, informal disciplinary proceedings all the way up to and including revocation of an insurer's license.

Since a substantial amount of the material required to be filed under this Section must be filed prior to its distribution, the Subcommittee hoped to lessen the problem of purchase in reliance upon disapproved material.

Section 7 – Authority of the Commissioner to Disapprove

SOURCE: NAIC Model Variable Contracts Regulation (See 2 NAIC Proceedings 1968)

COMMENT: This Section is similar to Article III, Section 6e and the comments made thereto are applicable here.

This Section was added to deal with any material which is required to be filed by law or provisions of the Regulation other than Article III, Section 6.

ARTICLE IV

Section 1 – Filing of Variable Life insurance Policies

SOURCE: Subsections a and c are new. The remainder of this Section is derived from the original NAIC Model Variable Contracts Regulation.

COMMENT: This Section requires specimens of "all variable life insurance policies, riders endorsements, applications, and other related documents which are to be attached to or made part of the policy," to be filed with the Commissioner and approved by him "in writing" prior to the use of that form in a particular state.

Despite the language of Subsection a, concerning procedures for approval, the language of this Section which requires approval "in writing," would not permit a "deemer" type approval unless such a deemer was specifically required to be allowed by statute. The Subcommittee took this position because they wanted the Commissioner to be forced to take an affirmative stand in policy and form approval. (See e.g. Article III, Section 1.)

The term "related forms" in the introductory paragraph of this Section does not include either "Information to Applicants" required by Article VII or "Reports to Policyholders" provided for in Article IX. However, these are also subject to approval prior to use. (See Article III, Sections 6 and 7.)

Subsection b gives the Commissioner authority to approve policies and forms which he deems to be not less favorable to the policyholder and beneficiary than those required by the model. It should be noted that there is a vast difference between the discretion to approve policy forms which are more favorable to the policyholder beneficiary (and implicitly the owner) and the discretion to impose "more favorable" provisions. Clearly, the Commissioner has both. However, his power in the latter instance does not stem from the model, since it speaks only in terms of the ability to "approve," but rather from his ability to change the regulation.

Subsection b is intended to allow companies to include provisions more favorable to the insured. This may be desirable for the insurer in order to promote uniformity of policy forms. For example, assume that State X allowed a two-year suicide exclusion and State Y allowed a one-year exclusion. The one-year exclusion is more favorable to the policyholder. Thus, this Section would enable the Commissioner of State X to approve a company's form which contained the more favorable one-year exclusion, thus permitting the insurer to have the same form in both states. The Commissioner of State X could not, pursuant to the model, impose the one-year exclusion on the insurer.

The determination of when a benefit is more favorable can be a very subjective determination. For example, a one-year "free look" would be a "benefit" to those who chose to take advantage of it. Those who had no intention of ever exercising such a provision and would be forced to bear the extra cost involved would be unlikely to look at this change as a "benefit." Thus, what may be a benefit for some would be merely an extra mandated cost for others. Flexibility by individual Commissioners in this area was intended to be preserved.

Not all variable life policies (in particular to tax qualified plans) will be subject to registration and other regulation by the SEC under the present regulatory scheme. However, the Subcommittee, as a general proposition, saw no reason why a different regulatory pattern should be developed by the states for these policies. Therefore, they generally provided that such variable life policies should be required to meet the same policy form standards, and conform to all the regulatory requirements applicable to registered variable life insurance. This intention specifically includes the minimum death benefit requirement.

However, there were some provisions which the Subcommittee determined were not necessary for tax qualified plans. These are delineated in Subsection c.

The requirements of Sections 2a and d form part of Rule 3c-4, and were intended to limit the "investment" nature of endowment or so-called "high cash value" policies. The Subcommittee clearly made no finding that such policies would, because of their increased cash value, be transformed into anything other than insurance or should lead to a different type of regulation. As a matter of fact, quite the opposite sentiment was revealed. (See e.g. NAIC August 14, 1974 Response to SEC Questionnaire, File 4-149.) The SEC implicitly claims jurisdiction over normal policies which do not comply with Section 2a and d. Because of the 3(c)(11) exemption this is not the case with tax qualified plans.

The Subcommittee clearly felt that dual regulation of a portion of an insurer under the Investment Company Act would inevitably weaken the Insurance Commissioner's ability to protect the public. Since the Subcommittee did not want variable life insurance written in such a manner as would be subject to this dual regulation they inserted the provisions of SEC Rule 3c-4 in the model regulation. This particular argument was inapplicable to policies (i.e. tax qualified plans) already exempt from SEC regulation.

While the Subcommittee was by no means convinced that variable settlement options would give rise to SEC jurisdiction, they decided to include Section 3q rather than risk this potential, through unlikely occurrence. This argument was likewise irrelevant in the case of tax qualified plans already exempted.

Quite aside from the foregoing reasons, the Subcommittee concluded that derivatives of variable life insurance could legitimately be used in various combinations with other products to fund pension plans. Such plans intended to be used as retirement vehicles might legitimately wish in their design to place greater emphasis on cash values such as, for example, in an endowment. While as previously noted, the Subcommittee specifically determined that the same general regulatory scheme should apply, the provisions noted in this Subsection were found to be inapplicable in light of legitimate pension design. It should be noted, however, that the provisions of Article IV, Section 3f and 2h are still applicable to tax qualified plans. (See also Article IV, Section 5c(6).)

Section 2 – Mandatory Policy Benefit and Design Requirements

SOURCE: Subsections a, c, and d are derived from the ALC-LIAA Joint Exemptive Petition to the SEC and are embodied in its Rule 3c-4. Subsection h is derived from the original NAIC Model Variable Contracts Regulation. The remaining Subsections in Section 2 are new.

Subsection a

COMMENT: Because of the Subcommittee's concern with variable life insurance improperly and erroneously emphasizing an "investment" nature, they determined for the time being to limit policies to those which provided coverage for the whole of life. Furthermore because of the potential for conflict which would hamper state regulation, inherent in dual regulation with the SEC, the Subcommittee determined that for the present only those policies exempt from such regulation would be allowed. (See Comment to Article IV, Section 1c.)

Subsection a has special relevance to the growing number of states which are enacting laws creating guaranty funds for life and health insurers. Most future laws on this subject will probably be based on the NAIC Model Life and Health Insurance Guaranty Association Act (1 NAIC Proceedings 1971 p. 160). (See, however 2 NAIC Proceedings 1974 p. 390.) This model act, in Section 3(2)(a) exempts from its coverage "any such policies or contracts, or any part of such policies or contracts, under which the risk is borne by the policyholder." On its face, this provision is at least a little ambiguous in the variable life insurance situation. However, the comment following this Section says, in part:

> Subsection 2(a) is directed toward variable policies and contracts. That portion of the contract where the risk if borne by the policyholder is excluded. However, the obligations of the insurer (e.g., mortality and expense guarantees) are covered. Furthermore, Section 8(10) provides that the Association's liability shall not exceed the contractual obligations of the impaired insurer.

The Subcommittee believes that all life insurance guaranty funds should cover variable insurance policies up to the minimum death benefit specified in each. Death benefits over the minimum and all cash values should be covered unless the loss is due to the actual investment performance of the separate account. The understanding and expectation of the Subcommittee was that such coverage did exist and that the NAIC model act properly does protect the policyholders from loss resulting from intentional fraud, other illegal acts, and negligence by the officers or directors or employees of the life insurance company. For example, if separate account assets are stolen or lost or if the officers replace good assets in the separate account with bad ones, that is not the kind of "risk" for which the variable life policyholder contracted. The guaranty funds should cover it. There are, of course, numerous possible variations on this theme. (See Comment to Article III, Section 1c(1).)

This Subsection requires the insurer to assume the expense risk of investment management at all times. Obviously, the capacity of the insurer to absorb expense price increases is a factor to be considered by the Commissioner in determining whether or not an insurer should be allowed to do business. (See Comment to Article III, Section 1c(1).) Another consideration for the Commissioner might well be whether or not an investment advisory contract guarantees that the advisory fee will not be raised.

If the insurer determines to invest in an underlying mutual fund which increases its fee, the insurer could not raise its deduction from the separate account except to the extent that it was currently deducting less than the maximum amount specified in the policy. If the policy provided for a maximum deduction of .75% or less (depending upon the amount in the separate account), and the maximum amount specified in the policy was already being deducted, the fee could not be raised at all.

At that point, the insurer would either have to absorb the increased cost or change funding mechanisms. Such a situation could well result in the desirability of making an investment management change. The likelihood for adverse impact on the underlying fund is a consideration for the Commissioner concerning the proposed method of operation pursuant to Article III, Section 1c as well as Article VI, Section 4. Article VI, Section 4 specifically requires an examination of the independence of the underlying fund. However, the Commissioner's obligation is to protect both the fixed and variable life insurance policyholders at all times. Thus, a situation could develop in which if the insurer was forced to absorb an exhorbitant loss from increased investment management costs, the fixed benefit policyholders would be disadvantaged in favor of the variable life insurance policyholders. This again demonstrates the danger of distinct separate account management as well as the fear that the policyholders and the insurer as a whole could be jeopardized by undue emphasis upon the separate account without taking into consideration the effect on policyholders in general.

The intention behind the insurer's assumption of mortality and expense risks in this Subsection follows Article VI, Section 6 of the original NAIC Model Variable Contracts Regulation which provides that unfavorable "expense and mortality results shall not affect. . .dollar amounts" (owing for variable benefits).

Subsection b

The primary purpose of this Subsection is to prohibit variable premium – variable benefit policies, although such policies do fall within the definition of variable life insurance. (See Article II, Section 16.) The Subcommittee took this position despite the fact that such policies would be permitted by SEC Rule 3c-4 and further despite repeated industry requests to allow variable premium policies.

The Subcommittee reached this determination because they felt that for at least the time being, such policies were too confusing for the general public to properly understand. The Subcommittee was particularly concerned that a radical increase in separate account investment performance leading to substantial benefit and premium increases could precipitate higher lapse rates. The Subcommittee was not convinced that the public would be likely to fully understand that separate account investment performance could be so successful that the individual could no longer afford to keep the policy. Another factor in their decision was the difficulty of cost comparison. For example, if benefits went way up premiums would also rise correspondingly. If beneits then fell, the policyholder could have paid vastly increased premiums over a period of years for no increased death benefit.

This Subsection was clearly not intended to preclude additional nonlevel premiums for substandard risks or incidental insurance benefits. (See Comment Article II, Section 8.) This Section does preclude policies with scheduled nonlevel premiums such as policies with a reduced premium during the early policy years, since this would involve a different policy design and not merely an "incidental insurance benefit."

The second sentence of this Subsection was inserted to allow preliminary term insurance for a period of up to 120 days. This was done primarily so that insurers which so wished could cover all persons immediately but still maintain uniform variable life insurance policy inception dates in order to provide simplicity in separate account operations and benefit determination. The period was limited because the Subcommittee felt that long periods of fixed preliminary term insurance would not be giving the insured what he thought he was buying, to wit: variable death benefits.

Preliminary term insurance cannot be used to avoid the protections of Article IV, Sections 3a(5) and g.

The Subcommittee required the premiums for preliminary term insurance to be stated separately either at the time the application was taken or in the receipt given when the premium was paid. (See also Article IV, Section 3s.) The word "rate" was inserted following "premium" because in some circumstances, because of different effective dates, the insurer will not necessarily know the exact period for which the preliminary term insurance will run.

The phrase "premium rate" was not intended to preclude an insurer from showing actual premiums but was intended to permit the showing of a rate of premium per thousand or other applicable basis either for the entire preliminary term period or on a per day basis.

The premiums or premium rates which must be shown are for the entire preliminary term policy including any incidental insurance benefits which may be sold in conjunction therewith.

Subsection c

COMMENT: Reserve liabilities for the guaranteed minimum death benefit (initial face value) must be maintained in the general account. (See Article V, Section 2.)

The minimum death benefit is only required to be applicable so long as premiums are duly paid. This would include situations in which a policy was properly reinstated. Thus, assuming duly paid premiums, the death benefit payable at anytime is the greater of the variable death benefit or the minimum death benefit adjusted by any policy loans, withdrawals, or surrenders permitted by Article IV, Section 4b.

The model regulation does not require a "minimum death benefit" (initial face value) guarantee with respect to "reduced" paid-up variable whole life insurance since the minimum death benefit guarantee is required only when premiums are duly paid. This condition is also contained in SEC Rule 3c-4.

Early drafts of the model regulation required a minimum death benefit guarantee in this situation. However, the Subcommittee determined that the cost of providing such a benefit was too great in relation to the corresponding benefit. This is because a relatively small decline in the value of the separate account portfolio could have a relatively great impact on the death benefit of a paid-up policy.

Furthermore, such a guarantee on a "reduced" paid-up policy could expose the insurer to risks not present under the original policy. In fact, with variable life insurance it is not at all unlikely that the traditional "reduced" paid-up insurance could in reality be "increased" paid-up insurance. After a period of good investment performance, it is possible that the guaranteed death benefit under a "reduced" paid-up policy could exceed the initial death benefit guarantee thereby exposing the insurer to an unanticipated risk and giving rise to solvency concerns.

It became clear that the imposition of a required minimum in this instance would in all probability have meant that such a nonforfeiture option would merely not have been offered.

In the situation where participating policy dividends are used to "purchase" additional paid-up variable life insurance additions (Article IV, Section 5c(3) the amount payable on death was intended to be increased by the then current amount of death benefit provided by these dividend options. Thus, it would equal the greater of the minimum death benefit or the variable death benefit adjusted for indebtedness plus the current amount of additions. The minimum death benefit itself would not be applicable to Article IV, Section 5c(3). (See Comments to Article IV, Section 5c(3).)

While "initial face amount" is an undefined term it should not be interpreted to include the amounts of any incidental insurance benefits.

See also Comment to Article II, Section 10.

Subsection d

COMMENT: See Comments to Article IV, Sections 1c and 2a.

Subsection e

SOURCE: New

COMMENT: Subsections e and f must be read together. Subsection e requires that excess investment performance (either positive or negative) must be applied only to provide policy benefits and defines the only methods by which such application may be made.

The effect of this Section is to limit policy designs (see Comment Article IV, Section 2a et seq.) to those which apply excess investment performance to provide adjustments to the amount of insurance, and further limits the types of insurance which may be offered.

Variations in net investment return credited to different classes of policies may be required for several reasons. For example, Article VI, Sections 4b(11) and (12) require that policy loan provisions be constructed in a manner which will not disadvantage nonborrowing policyholders. Moreover, mutual insurers are prohibited from making policy loans from the general account. (See Comments Article IV, Sections 4b(11) and 12.) Thus, this Subsection was not intended to preclude the application of differing rates of net investment return to different classes of policyholders in order to avoid discriminating against nonborrowing policyholders as required by Article IV, Section 4b(11).

Another possible instance of the application of differing rates of investment return within the same separate account would be to reflect different charges applicable to different classes of policies. This could occur where different policy designs permitted to utilize the same separate account (see, however, Article VI, Section 1f) require different charges for mortality guarantees, or where different tax liabilities are applicable to different classes of policies.

Paragraph (1) permits excess investment performance to provide paid-up insurance amounts and encompasses the so-called "Equitable" policy design. Except for policies exempted under Article IV, Section 1c, the "same period as the basic insurance under the policy" refers to the lifetime of the insured. (See Article IV, Section 3a.)

Under Paragraph (1) the increases or decreases in death benefits and reserves respectively, resulting from excess investment performance (positive or negative) will bear the same proportion to each other as the death benefit and reserves for single premium fixed benefit life insurance bear to each other. The reserve for the initial face amount of the variable policy under this design will equal the corresponding fixed benefit life insurance reserve computed at an interest rate equal to the assumed investment rate. (See Article V, Section 1.) In addition, Paragraph (1) permits excess investment performance to be applied to term insurance amounts.

Paragraph (2) refers to the so-called "New York Life Design" and permits excess investment performance to provide additional insurance amounts (positive or negative) such that the reserves for the total policy (not merely the initial face amount) bear the same relation to the total death benefit as the corresponding fixed benefit life insurance reserve, computed at the interest rate equal to assumed interest rate, bears to the death benefit. This may be viewed as a special form of paid-up decreasing term additions or as premium paying whole life additions where the additional "premiums" must be provided through future application of rates of net investment return in excess of the assumed interest rate additions and additional "premiums" can, of course, be negative. Under this design if the net investment return were higher than the assumed interest rate, and subsequently the net investment return was exactly equal to the assumed investment rate, then death benefits would gradually decline form the level reached during the earlier period, since there would not be current "excess investment performance" sufficient to maintain the higher level of benefits.

The term "fixed benefit" in Paragraph (1) was intended to refer to level nonvarying term insurance adjustments. However, apparently this term when read in conjunction with Article VI, Section 3e(1) may be producing several unintended results. The interpretation of this term has caused confusion and has erroneously led some persons to believe that the Subcommittee intended that the reserve for the level term coverage ("fixed") would necessarily have to be transfered to the general account. In particular the interpretation could lead to anomalous results when adjustments were negative since it would imply a negative "reserve" in the general account. Since this interpretation was not the intention of the Subcommittee, clarifying amendments may be desirable.

Amounts of such "fixed benefit" term insurance adjustments (positive or negative) were intended to be a part of the variable death benefit.

Subsection f

SOURCE: New

COMMENT: Article II, Section 11; Article VI, Section 2 and Section 7a combined determine the calculation of the net investment return as a rate and not as an amount.

Article IV, Sections 2e and f combined determine and specify the only ways the net investment return can be applied, and require that the full net investment return must be applied in the specified manners.

Since the net investment return is a rate, the word "amount" in this Subsection refers to the product of the net investment return times the benefit base.

Subsection e requires that the total difference between the net investment return and the assumed investment rate, multiplied by the benefit base, be applied to adjust benefits and specifies the permissible methods. Thus, the effect of Subsection f is to assure that the result of the assumed investment rate times the benefit base is also applied under the policy. (See Comment Article II, Section 4.)

Subsection g

COMMENT: This Subsection requires death benefit determination to be at least annually. Subsection 2h requires cash values to be determined at least monthly while Article VI, Section 1e (as well as Article IV, Section 3(e)(3) requires underlying separate account assets to be valued at least as frequently as benefits are determined but in any event at least monthly. The Comments to these Sections refer to the Subcommittees thinking with regard to the frequency of the valuations covered thereby.

Article IV, Sections 2h and 3e(3) and Article VI, Section 1e in combination require all policy benefits to commence varying according to the terms of the policy not later than the next separate account valuation date after a maximum interval of one month from the effective date of the policy. Subsection g, therefore, would permit a policy design under which the first change in the variable death benefit may not occur until as late as the first policy anniversary and subsequent changes may occur as infrequently as each anniversary thereafter.

With variable life insurance, the less frequently policy benefits are calculated the greater the risk on the insurer becomes, and the smaller the risk of adverse investment performance on the policyholder. In fact, between benefit valuation dates, a variable life insurance policy is a fixed benefit policy. Regardless of how poor separate investment performance is, between valuation dates the insurer is obligated to pay fixed benefits as determined at the last benefit valuation date.

Depending on separate account investment experience, less frequent death benefit valuation can be advantageous or disadvantageous. Certainly benefits will not achieve a high level of dollar cost averaging. However, there is a possible advantage which might arise out of the certainty that for the next full valuation period (up to one year for death benefits) the entire risk of either adverse or favorable separate account performance is shifted to the insurer and benefits will be as stated on the last determination date. There may be a number of counter balancing reasons why persons might not wish to purchase a policy in which death benefits were valued annually. The Subcommittee, however, decided that prospective purchasers of variable life insurance should not be precluded from purchasing such policies as a matter of law.

(See Comment to Article IV, Section 2h.)

Subsection h

This Subsection requires cash values (nonforfeiture benefits) to be determined at least monthly.

It was the expectation of the Subcommittee at the time the model regulation was drafted that cash values would be computed as of the valuation date immediately preceding the request therefor. While there is no technical reason why "forward pricing" could not be utilized, there are practical reasons which led the Subcommittee to conclude that its use under normal circumstances would probably be inappropriate.

A primary objection to forward pricing is that the policyholder would never be aware of a cash value in advance of a request therefor. Furthermore, with less frequent valuation and forward pricing, there would be a necessary delay in the insurer's acting upon the policyholder's request. Because of this delay, it is unlikely that an insurer could adopt both forward pricing and infrequent valuation.

The Subcommittee was unaware of any company which intended to utilize forward pricing with respect to cash values and death benefits. Such use would seem to be always inappropriate.

A substantial delay in responding to a request for cash values could very likely be considered an unfair trade practice. Thus, while no provision of the model regulation specifically precludes forward pricing, the Commissioner would have authority to preclude it pursuant to Article III, Section 1c(1). An insurer proposing to use forward pricing in a given instance would have to convince a Commissioner that such use would be neither unsound nor be unfair to the policyholders. Certainly, the (C4) Subcommittee's understanding was that backward pricing would be utilized.

Parenthetically several factors virtually require that backward pricing be utilized in determining death benefits. Death benefits must be determined as of the date of death – not the date the insurer receives notice of death. It would not be equitable to allow the death benefit to be affected by events which occurred after the happening of the insurable event. Thus, backward pricing is essential with respect to death benefits even though the result is an extended risk on the company of adverse investment performance between the date of death and the notice to the insurer thereof. This time lag can be quite extensive and potentially expensive. Similarly, backward cash value determination of death benefits and cash values would appear to be the general rule.

Either the policy or a statement filed with the Commissioner of the state in which the policy is to be delivered (see Article III, Section 6) must describe the method of computation of such values. Such method of computation is required to be in accordance with actuarial procedures which recognize the variable nature of the policy. While the Subcommittee was, of course, aware that the application of the excess of net investment return over assumed the investment rate to determine benefits is a complex calculation, it is expected that insurers will make every effort to describe the process in as simple a manner as possible. Naturally, if the insurer opts to file its statement with the Commissioner, a technically oriented description would be more acceptable than would be the case if the same description were placed in the policy. An insurer choosing to file with the Commissioner would be obligated to call such filing to the policyholders' attention in the policy. In any event a technical benefit base description must exist somewhere and must, if not placed in the policy, be filed with the Commissioner as part of the plan of operation. (See Article III, Section 1c.) Furthermore, the filing route would not relieve the insurer from its obligation to disclose the operation of the policy in general terms. (See Article III, Section 3; Article IV, Section 3a and 3d; and Article VII, Section 1.)

The most important portion of this Section requires that policy benefits be designed in such a manner that the Standard Nonforfeiture Law is satisfied with necessary modifications for variable benefits. This is done by mandating nonforfeiture benefits, which, assuming that at all times during the life of the policy the full net investment return (Article IV, Sections 2e and f) exactly equals the assumed interest rate, would at least equal the minimum values required for a fixed benefit policy with similar premiums and benefits. This calculation must not use an assumed investment rate in excess of the maximum provided in the Standard Nonforfeiture Law of that state. (See Article IV, Section 2g.)

Nonforfeiture benefits are defined by the Standard Nonforfeiture Law in terms of the present value of future benefits minus the present value of future adjusted premiums. Nonforfeiture benefits are intended to be based upon the variable death benefit and, for this purpose only, the minimum death benefit guarantee (see Article V, Section 2) is not relevant.

Including the guaranteed minimum death benefit (or any incidental benefits which may also be provided) in the nonforfeiture calculation would be inappropriate to the nature of such benefits and would have the effect of producing insignificantly small fixed nonforfeiture benefits to supplement the basic nonforfeiture benefits provided by the policy. This would be inconsistent with the purposes for which variable life insurance was designed. Hence, the last sentence of Subsection h was inserted.

Subsection i

COMMENTS: None

Section 3 – Mandatory Policy Provisions

SOURCE: Portions of this Section are derived from the original Model Variable Contracts Regulation.

Subsection a

COMMENT: The primary purpose of this Subsection is disclosure in order to assure that the policyholder is aware of the risks that both he and the insurer are assuming. This Subsection requires that the statements mandated therein be prominently displayed on the cover page of the policy. (See also Article VIII – Applications.)

At one time the regulation required contrasting color. This was amended to alternatively permit bold face type because of possible color printing cost considerations. Clear readability and prominence are required no matter what printing form is utilized.

Paragraphs (1) and (2) require a statement of the conditions under which the death benefit and cash values will be variable or fixed. This would include a statement of the minimum death benefit and any other guarantees.

With respect to Paragraph (1), contract benefits would be fixed any time the policy so specifies. For example, between valuations, benefits are fixed. When the initial face value guarantee is in effect, death benefits are fixed. Incidental insurance benefits such as accidental death would be fixed. Individual policy provisions could result in a number of additional possibilities.

Guaranteed "minimum cash values" under Paragraph (2) would exist any time the insurer chose to make such a guarantee and the policy so specified. In effect a guaranteed "minimum" cash value would exist between valuation dates. While the Subcommittee is not presently aware of any insurer which intends to make the guarantee with respect to the variable portion of its policy, it is not outside the realm of possibility that some day an insurer would undertake to offer such a benefit. Article IV, Section 2h provides that the policy shall be designed in a manner in which if the net investment return at all times equals the assumed investment rate that nonforfeiture values must equal the minimum values required by the Standard Nonforfeiture Law. (See also Article IV, Section 3d.)

The intention of this Section was merely to assure proper notification of any guarantee which might exist.

Paragraph (3) requires a description of the operation of the minimum death benefit (initial face value) guarantee. (See Article II, Section 10 and Article IV, Section 2c.) The text refers to premiums having been paid when due but should be read "duly paid" in order to include proper reinstatement situations. (See Article IV, Section 3c.) When policy loans or withdrawals are "outstanding," the minimum death benefit will still be in effect but will be reduced by the amount "outstanding." Naturally, the word "outstanding" in this Paragraph refers to "loans" or "withdrawals" and not "surrenders." As noted in the Comment to Article IV, Section 2c, the "initial face amount" does not include incidental insurance benefits.

Paragraph (4) is self-explanatory. (See also Comment to Article IV, Section 2h.) The term "variable death benefit" (Article II, Section 15) could be substituted for "variable amount of insurance payable at death."

Paragraph (5) is the "free look" provision of the model regulation. The time periods apply from the date of execution and receipt of the variable life insurance policy, not any preliminary term or other separate policy. Refunds apply to the premium for the variable life insurance policy and all incidental insurance benefits provided therewith except for preliminary term insurance issued pursuant to Article IV, Section 2b. It would be inequitable, for example, to allow the insurer to retain disability waiver of premiums for a policy which has been returned and is not in effect.

The date of execution of the application is intended to refer to the latest date upon which the applicant is required to give written acknowledgement of receipt of the disclosure document required in Article VII. It is not intended, for example, to refer to the date upon which medical evidence is given.

The model regulation does not now specifically require a separate notice of refund rights in addition to the captioned provision on the cover page of the policy. However, the authority to require such a notice, if desired by the Commissioner exists pursuant to Article VII, Section 1 and Article III, Section 6e.

Paragraph (6), reflecting the Subcommittee's determination that fixed benefit life insurance is substantially similar to variable, incorporates by reference any other items on the cover page which are required by the promulgating state's laws or regulations.

Subsection b

COMMENT: This Subsection applies the standard life insurance policy grace period to variable life insurance. The intention behind it is that if premiums are paid within the grace period there will be no change in either variability or amount of benefits owing under the policy. Policy benefits must be the same as if the premium were paid on the due date.

Subsection c

COMMENT: This Subsection is derived from the original Model Variable Contracts Regulation. It was adopted from the normal fixed benefit life insurance reinstatement provision with modifications required by the nature of variable life insurance.

Just as with fixed benefit life insurance, evidence of insurability is required in order to protect against anti-selection. With death benefits and cash values subject to fluctuation a fixed benefit type reinstatement would have offered an opportunity for speculation against the insurer. A policyholder could lapse his policy and, assuming he remained insurable, he could wait to see whether separate account performance resulted in increased or decreased benefits. If benefits decreased he would not reinstate and could purchase a new policy. If benefits had increased, in the absence of Paragraph (2) of this Subsection, he would pay back merely the overdue premiums at interest.

While this might appear to be an attractive scenario, it would rarely be in either the policyholder's or the insurer's interest. The insured is always risking his insurability. More importantly, however, in lapsing and purchasing a new policy he would be paying policy acquisition costs again as well as reestablishing the suicide and incontestability clauses etc. (See e.g. NAIC Model Replacement Regulation 1 NAIC Proceedings 1970 p. 345.)

Even under the most favorable circumstances the above scenario presumes the unlikely possibility that the typical policyholder is able to successfully predict investment results significantly more accurately than the insurer.

Reinstatement in the situation described above could also be costly to the insurer (and in the case of an insurer issuing participating policies, other classes of policyholders). It imposes a significant investment risk. For example, in variable life insurance the allocation of premium to the separate account is made on a uniform basis independent of the date the premium is actually paid. Consequently, cash will have to be advanced from the general to the separate account to "purchase" the investments necessary to support the promised benefits. Such advances create an investment risk for the insurer. If the premium is not paid by the policyholder, the advance from the general account must be reversed when the policy lapses at which time the market may be depressed.

This, of course, is in addition to the normal risks of anti-selection and administrative costs of keeping the policy in suspended animation during the reinstatement period.

In response to these problems the model regulation conditions reinstatement on the payment of the greater of: (1) both of overdue premiums and outstanding indebtedness at the maximum policy loan interest rate permitted by law in that state or (2) 110% of the increase in cash surrender value resulting from the increase.

Subsection d

COMMENT: (See Comment to Article IV, Section 2h.) While this description is required elsewhere in different degrees of technicality (see Article VII, Section 1 and Article IV, Section 2), the purpose of this Section is to make it a contractual matter.

Subsection e

COMMENT: (See Comment to Article IV, Section 3d.)

This Section makes the identification of the separate account utilized a contractual matter. Paragraph (1) is consistent with the Comments contained in Article IV, Section 1c and 2a, as well as Article VI, Sections 1f and g in order to assure regulation of variable life insurance which will not be detrimental to the public or the policyholders of an insurer.

Paragraph (2) is derived from the original Model Variable Contracts Regulation Article IV, Section 2. It has the effect of insulating the assets underlying separate account liabilities.

The separate account will not uncommonly contain assets which are not required to cover liabilities under variable life insurance policies, e.g. start-up funds or seed money to raise the separate account to an operative level. Other examples might include a reserve for deferred taxes or a mortality fluctuation reserve. The minimum amount required to be in the separate account is dependent on the benefit base. (See Article IV, Section 2a.)

Clearly, the amount in the separate account, whether it be in excess or less than the insurer's liabilities, is totally unrelated to the policy benefits payable under the policy. The only concern with the amount in the separate account is one of solvency – i.e. does the insurer have sufficient funds to fulfill its obligations? The fundamental point is that benefits owed under the terms of the policy are totally independent of the actual amounts in the separate account. The purposes of the separate account are (1) to provide an internal index against which to measure policy benefits; (2) to maintain solvency; and (3) to isolate the different risks associated with different classes of policyholders of the same insurer.

Naturally, general account assets always stand behind all liabilities of the insurer including its variable life insurance obligations. It should be further noted, however, that Article IV, Section 3e(1) provides that such a variable life separate account, subject to one limited exception, "shall be used to fund only variable life insurance benefits." Furthermore, Article VI, Section 1g provides that "variable life insurance separate accounts shall not be used . . . for the investment of funds corresponding to dividend accumulations or other policyholder liabilities not involving life contingencies." (See Comment Article IV, Section 1c and 2a.)

The provisions of Article VI, Section 7 were never intended to preclude the insurer as a whole from recovering the "seed" money placed in its separate account, or for that matter any excess of separate account assets over liabilities.

Paragraph (3) makes a contractual provision out of the obligations of Article VI, Section 1e.

Subsection f

COMMENT: Subsection f is designed to provide effective protection for variable life insurance policyholders against the possibility of an insurer's acquisition costs becoming too high with the resulting premium being unreasonable in relationship to the benefits provided. The approach of this Subsection reflects the Subcommittee's conclusion that the only form of control which will provide meaningful safeguards to purchasers is one which is applicable to the total premium charged rather than to an artificial subdivision thereof. The Subcommittee considered and rejected any approach which attempted to regulate the expenses of the insurer since this would not necessarily affect the premiums charged the policyholder. This Subsection, in effect, requires vastly increased nonforfeiture benefits if a premium which exceeds the conditional maximum is charged. This approach was chosen by the Subcommittee rather than direct premium rate regulation – a concept alien to the life insurance in the United States.

Detailed statements concerning the approaches considered and discarded by the Subcommittee are contained in the NAIC's Comments to the Securities and Exchange Commission. (See File 4-149 March 11, 1974, and August 14, 1974.)

The following example provides a practical illustration of how this Section would operate.

The "Conditional" Maximum Premium Rates

The "conditional" maximum premium rates vary by plan, issue ages and the maximum interest rate permitted by a state's nonforfeiture law. For a given plan and age (and statutory interest rate), the "conditional" maximum gross premium is computed using standard actuarial values contained in published tables. Once computed, it if a fixed, known amount.

If an insurer's gross premium for a particular plan/issue age exceeds the "conditional" maximum premium, the nonforfeiture benefit provided by the policy must be at least equal to the regular statutory minimum nonforfeiture benefit plus the present value of an annuity of the excess of the gross premium over the "conditional" maximum. The present value factor which would be applied to any excess if a standard actuarial value contained in published tables. Thus, the "enhanced" minimum nonforfeiture value which the policy must provide is a simple, straight-forward calculation.

Test Against "Conditional" Maximum Premium Rates

The actual gross premium for the particular plan/issue age is compared to the "conditional" maximum premium rate for that particular plan/issue age. Illustrated below are the "conditional" maximum premium rates for four plans (assuming a 3-1/2% statutory interest rate).

Conditional Maximum Premium Rates

Issue Age*	Plan: Whole Life	Life 65	20 PL	30 PL
5	$ 12.06	$12.50	$ 12.50	$ 12.50
10	13.46	14.08	14.08	14.08
15	15.03	15.87	15.87	15.87
20	17.00	18.18	18.18	18.18
25	19.56	21.28	21.28	21.28
30	22.45	25.00	25.00	25.00
35	26.36	30.30	30.30	30.30
40	30.82	37.04	37.04	34.12
45	37.05	47.62	47.62	39.60
50	46.54	66.67	56.33	48.36
55	58.07		66.32	59.11
60	74.18		80.46	74.59
65	97.33		101.46	97.39
70	116.13		118.00	116.13
71 & over	142.86			

*There is a specific maximum premium for each issue age but only fifth ages are illustrated.

If the actual gross premium does not exceed the "conditional" maximum, then the conditions imposed by the "conditional" maximum are not applicable. If the actual gross premium exceeds the "conditional" maximum, then the present value of that excess must be computed and added to the regular minimum statutory nonforfeiture benefit otherwise required, to determine the "enhanced" minimum which the policy must meet.

The present value at the date of issue for an excess of $1 (assuming a 3-1/2% reserve interest rate is used in the policy) for the same plans and issue ages illustrated above, is shown below.

Present Value at Date of Issue of an Excess of $1.00

Issue Age	Plan: Whole Life	Life 65	20 PL	30 PL
5	$25.63	There cannot be any excess Gross Premium for these ages and plans (except in the case of "qualified plans"), since the Conditional Maximum Gross Premium is equal to the Maximum Gross Premium which would qualify pursuant to Article IV, Section 2d.		
10	25.07			
15	24.39			
20	23.63			
25	22.74			
30	21.70			
35	20.47			
40	19.06			$17.22
45	17.49			16.36
50	15.79		$13.04	15.19
55	13.99		12.24	13.74
60	12.13		11.18	12.06
65	10.29		9.87	10.28
70	8.55		8.41	8.55
71 & over	6.99		(Cannot Exceed)	

Test Against "Conditional" Maximum

The actual gross premium is compared to the "conditional" maximum (see table of Conditional Maximum Premium Rates), which indicates that the maximum for this plan/age (35 Whole Life) is $26.36. The actual gross premium of $27.36 exceeds this maximum by $1.00. The minimum nonforfeiture benefit required by the Standard Nonforfeiture Law, if a 3-1/2% interest rate, is shown below in Column 1. Column 2 shows the present value of the $1.00 excess of the gross premium. Column 3 shows the "enhanced" minimum nonforfeiture benefit which the policy must provide, which is the sum of Columns 1 and 2.

Duration	1 Regular Min.N.F. Benefit		2 PV of $1.00 "Excess" Gross Premium		3 "Enhanced" Min. N.F. Benefit
0	$-30.75	+	$20.47*	=	$-10.28 (use zero)
1	-17.26	+	20.20	=	2.94
2	3.40	+	19.93	=	16.53
3	10.83	+	19.64	=	30.47
4	25.39	+	19.36	=	44.75
5	40.27	+	19.06	=	59.33
10	119.21	+	17.49	=	136.70

*This value is obtained from the previous table. Further durations were taken from the same actuarial table as used for duration zero.

The premium rates set forth in the Model Regulation represent premium rates for the life paid-up at 65 plan at issue ages 0 to 50, the 15 pay life plan for issue ages 51 to 70 and the whole life plan for issue ages 71 and over. It should be noted that this is recognized in item (1) of Article IV, Section 3f(B) where the present values are set forth. These changes in plan create the apparent discontinuities in the premium rates between ages 50 and 51 and also between ages 70 and 71 where the premiums actually decrease.

The addition to the conditional premiums rate authorized by Subparagraph (2)(A) reflects the Subcommittee's recognition that a substantial portion of expenses are independent of policy size and the consequent need to provide greater expense margins for small policies (below $10,000 of initial face amount).

The effect of this allowance, therefore, is to increase each conditional premium rate per thousand (shown in the Table of Rates) by $1.00 if the initial face amount of the policy is below $10,000. Thus, for example, a $5,000 policy would receive an extra total expense allowance of $5.00 per year.

The Subcommittee did not intend to require that Subsection f be included in each policy form; rather it was intended that all policies comply with the requirements of the Subsection.

The Subcommittee expects to periodically review the Table of Conditional Maximum Premiums to detemine their continued appropriateness.

Subsection g

COMMENT: This Subsection attempts to provide a reasonable basis for a policyholder to convert to fixed benefit life insurance without unfairly reincurring acquisition costs and regardless of his current insurability.

The Subcommittee recognized that unlike a security, life insurance cannot equitably be made to be freely redeemable. Thus, concepts developed under the securities laws could not be applied to life insurance. (For a detailed discussion of this area, see NAIC Comments to the SEC File 4-149, March 11, 1974, and August 14, 1974.)

The Subcommittee felt that possible lack of understanding by the public of the new variable life insurance product might result in policyholders buying variable policies and deciding subsequently that they really should have purchased fixed benefit coverage. It was felt that eighteen months was a reasonable period in which to make such a decision.

It was presumed that purchasers of variable life insurance policies intended to secure insurance protection and, therefore, that the fixed benefit conversion privilege provided by this Subsection was a more suitable method of providing protection against inappropriate sales than to require articifically high early nonforfeiture benefits.

Of course, this Subsection is in addition to traditional nonforfeiture benefits as well as the "free look" provided for in Article IV, Section 3a(5).

This Subsection, as currently drafted, may contain technical deficiencies which may (1) be producing the unintended result of encouraging improper speculation by policyholders against the insurer and/or other classes of policyholders, and (2) not appropriately cover all possibilities. This may produce anomalous results in some situations such as where both the premium and nonforfeiture benefits for the variable policy exceed that for the fixed benefit policy resulting from the conversion. Thus, this Subsection may require reexamination from a technical point of view.

The "Information to Applicants" as required by Article VII was intended to include notice of the conversion privilege of this Subsection either pursuant to Article VII, Section 1 or by specific amendment.

Subsection h

COMMENT: The requirements of this Section are commonly required by state law. (See e.g., N. Y. Ins. Law Sec. 155.) They were originally imposed to prevent the insurer from incorporating by reference in its policy, provisions which were contained in documents to which the insured has limited access. The mandates of this Section are not entirely true since, of course, statutorily required provisions are commonly implied in policies. Furthermore, judicial construction is, of course, imposed on contracts.

This provision would not destroy any policyholder's rights as a third party beneficiary of a contract made by the insurer for the policyholder's benefit assuming any such rights exist. Such provision was designed to protect the policyholders from losing any rights, not to destroy rights arising outside the contract.

Subsections i - n

COMMENT: These provisions are merely restatements of traditional life insurance policy provisions.

Subsection o

COMMENT: This Subsection provides another example of a required filing which is not enumerated in Article III, Section 6e. The purpose of this provision is to make the mandates of Article VI, Section 6 into a contractual matter.

Subsection p

COMMENT: The deferment contemplated by this Section might be necessary in times of financial difficulty when in the opinion of the Insurance Commissioner there might be a "run" on the insurer which would jeopardize the remaining policyholders. This might also exist in a liquidation, a situation in which the Commissioner might allow death benefits to be paid but not cash values, pending the liquidation process.

Insurers, just as they are exempted from the securities laws, are exempted from the federal bankruptcy laws in order that liquidation can take place in a manner which will serve to protect the policyholders. This protection of all policyholders (variable and fixed) would be placed in severe jeopardy were the variable life insurance separate account given preferential treatment over the general account.

This provision is similar to one which is required in most states for fixed benefit life insurance in order to protect the policyholders in the instances we described. This Section grew out of the same economy which produced the SEC. Although relatively few insurance companies failed during the depression (NAIC March 11, 1974 Comments to the SEC, p. 42), there was a concern that a "run" on insurance companies in a future depression could have very severe consequences not only on the insurers and their policyholders, but to the general economy and government (Gregg, Life and Health Insurance Handbook, 2d edition, p. 1151).

Again, it is important to realize that a variable life insurance separate account is not a severable entity but rather an integral part of the insurer. A separate account alone could not operate a variable life insurance policy. A substantial part of the reserve underlying a variable life insurance policy is in the general, not the separate, account at any given time. Thus, a combination of the two is required in order to pay benefits. Without the protection of this Section, the Insurance Commissioner might be in the position of being able to protect the policyholders in a liquidation only to the extent of the reserves in the general account, again illustrating the danger of dual authority over this accounting mechanism.

This Section has particular importance to variable life insurance. Since the "separate accounts" portfolio may consist of equity investments to a much larger extent than fixed benefit life insurance, determination of the proper amounts payable under the policy will be difficult at best during periods when the stock exchanges are closed.

When a policy is in a variable nonforfeiture benefit, there is no minimum death benefit. Therefore, any deferment under this Subsection applies to the entire death benefit. When a policy is in a fixed benefit nonforfeiture option, it is intended that the normal fixed benefit deferment provision would be permissible.

When a policy is not in a nonforfeiture option and the minimum death benefit guarantee is applicable, it was not deemed to be appropriate to defer that portion of the death benefit which was determinable (the minimum death benefit). Therefore, just as in fixed benefit life insurance no provision is made for deferment of death benefits to the extent of the minimum.

The phrase "except when used to pay premiums" is intended to apply to the payment of premiums under an automatic premium loan provision as permitted in Article IV, Section 5d and not to any other situation.

Subsection q

COMMENT: While the Subcommittee was not of the opinion that variable settlement options would invoke SEC jurisdiction, they wanted to be sure that no one would attempt to impose dual regulation. Thus, they required all settlement options to be fixed benefit. (See Comment to Article IV, Sections 1c and 2a.) The policy must contain settlement options and they cannot be on a basis other than fixed benefit.

Subsection r

COMMENT: The function of the schedules required by this Subsection is to set out the cash values under the policy at specified durations by $1,000 of variable death benefits then in force, regardless of investment performance. The schedules do not involve assumptions as to what the amount of variable death benefit or cash values will in fact be at the specified future durations.

There are no hypothetical assumptions utilized in the schedules required by this Section. Paragraph (1) of Subsection 3r is designed primarily for use with variable life insurance policies following the so-called "New York Life" design. Under this design the cash value per thousand dollars of insurance at any duration will be a fixed percentage, regardless of separate account investment performance. Therefore, there is no need to utilize any assumptions in compliance with this Section.

Likewise, the schedules required under Paragraph (2) of Subsection 3r do not require the use of any hypothetical assumptions as to investment return. This Paragraph is intended to be utilized by those policies following the so-called "Equitable" design. It requires one schedule for the cash value of the death benefit or per thousand dollars of insurance assuming that net investment return is always equal to the assumed interest rate. The second schedule is in effect a description of what adjustments will have to be made in order to determine cash value assuming only that net investment return does not precisely equal (either positively or negatively) the assumed investment rate.

The answer in this schedule would likewise be the same regardless of what actual or hypothetical investment returns were assumed. Therefore, the use of hypothetical assumptions as to investment returns is not relevant to any of the schedules under this Subsection. Furthermore, none of the schedules involve projections of past experience into the future or attempted projections of future investment experience, and the limitations of Article VII, Section 8 have no relevance to this Section.

The description of the cash value is intended to apply to the cash values as of the end of the policy years or at attained ages, and not to interim or interpolated cash values.

(See Article IV, Section 2h.)

Subsection s

COMMENT: See Comment to Article IV, Section 2b.

Subsection t

COMMENT: None

Subsection u

COMMENT: An example of what is anticipated by this Section is provisions of state law or regulation.

Section 4 – Nonforfeiture, Partial Withdrawal, Policy Loan, and Partial Surrender Provisions

SOURCE: New

Subsection a

COMMENT: A variable life insurance policy must provide a "cash value." (See *Article IV, Section 2h.) In addition,* however, nonforfeiture benefits must be offered in compliance with this Subsection. Paragraph (1) prohibits variable extended term insurance for the time being. (See Comment to Article IV, Sections 1c, 2a, and 3q. Paragraph (2) is self-explanatory. Paragraph (3) allows an insurer to limit certain nonforfeiture benefits to a reasonable minimum amount. In other words, the regulation recognizes that costs associated in offering certain benefits in minute amounts may be unrelated to the size of the benefit. Therefore, it was felt unreasonable to require an insurer to absorb costs below a reasonable minimum benefit amount. The Commissioner must ultimately approve of the "reasonable minimum."

This Section would not preclude a nonforfeiture benefit providing extended term insurance commencing on the premium due date for a period determined by the cash value determined as of the date on which notice is received requesting such option or the end of the grace period if no such election is made.

Subsection b

COMMENT: Policy loans were one of the most troublesome areas of the Model Regulation to the Subcommittee. Numerous alternatives were discussed. Policy loans are, of course, not free from problems with respect to fixed benefit policies. However, the nature of variable benefits seemed to magnify an already complex situation. Some of the problems are old: e.g. equity between borrowing and nonborrowing policyholders, and concerns involving solvency and policyholder speculation arising out of policyholders borrowing at comparatively low interest rates. However, some problems such as fluctuating cash values are new.

The Subcommittee at one time seriously considered the abolition of variable life insurance policy loans as a solution to these perplexing problems. Other possibilities included variable principal policy loans or "unit" withdrawals. These were ultimately rejected because of possible usuary problems as well as the confusion that they were likely to generate. The result of this dialectic process is this Subsection.

The Subcommittee ultimately based this Subsection on its convictions that variable life insurance was essentially the same as fixed benefit life insurance. Therefore, they concluded that variable life insurance policy loans should resemble fixed benefit policy loans to the maximum extent feasible. Aside from the "familiarity" argument, the Subcommittee intended to do as much as possible to protect the tax deductibility of policy loan interest, lest others misinterpret the nature of what is in fact a policy loan.

See commentary to Paragraph (7) for discussion of the term partial withdrawal.

Paragraph (1) has apparently caused some confusion as to the minimum and maximum amounts of loans which are required. This Paragraph requires that the insurer (subject to the provisions of Paragraph (8)) must offer a policy loan of at least 75% of the policy's cash value. The 90% maximum limitation does not apply to anyone other than stock insurers (see Paragraph (12)) and then only if the loan is made from the general account. This limitation restricts policy loans from the general account to a maximum of 90% in order to provide some hedge against the cash value declining to a point where it is exceeded by policyholders indebtedness. (See Paragraph (6).) The 75% minimum is provided to prevent an insurer from providing a policy loan right which was so small as to be illusory. Thus, the 75% limitation, in effect, requires that the insured must be able to borrow up to the percentage of cash value specified in the policy. The regulation requires that this percentage (subject to Paragraph 8) cannot be less than 75%.

Paragraphs (2) and (3) are self-explanatory. Paragraph (4) should refer to the Comments to Article IV, Sections 2d and 3a(3). Paragraph (5) is self-explanatory.

Paragraph (6) was intended for those situations in which the indebtedness outstanding exceeds the policy's cash values. This could occur when a loan is made from the general account, and cash values decline (see Paragraph (11) and (12)) or as in fixed benefit life insurance when interest owed continues accruing and is not paid. It is primarily the former instance which the Subcommittee had in mind in inserting this Paragraph.Thus, rather than merely allowing the insurer to cancel the policy, this Paragraph requires the insurer to allow the policyholder to immediately repay the excess indebtedness over his present cash value. The Subcommittee fully recognized that this placed a substantial risk on the insurer during the thirty-one day period. Furthermore, they were aware that in fluctuating markets the insurer could be forced to send frequent notices. However, this is the risk the insurer must take, and is one of the reasons for the 75% and 90% limitations of Paragraph (1).

Paragraph (7) is the Subcommittee's response to one of the differences inherent in variable life insurance. A practical result of Paragraphs (11) and (12) is that policy benefits of a mutual policyholder will in all probability not vary (other than to the extent of interest payments) to the extent of his use of cash values. As a result repayment of this indebtedness will in all probability not place the policyholder in the same position, benefit wise, as he would have been had not loan been made.

It is for this reason that the Subcommittee struggled with the terminology "policy loan" and "partial withdrawal." There was some concern that use of the term "policy loan" would be misleading since unlike in fixed benefit life insurance the policyholder might erroneously believe that full repayment would have no effect on policy benefits. However, the term "policy loan" was more familiar to consumers and might be more easily understood. Ultimately, the Subcommittee determined that the provision could be referred to as either a loan or withdrawal as long as it was at least as favorable to the policyholders as required by the Subsection. There was some concern over marketing practices which might try to mislead purchasers into believing that either was more favorable than the other. However, it was determined that Article III, Section 4 provided ample authority to police this potential practice.

Paragraph (7) was intended to allow but not to require the insurer to permit full restoration of benefits upon the repayment of 110% of the increase in cash value and the furnishing of evidence of insurability satisfactory to the insurer. The 110% repayment is inserted to discourage speculation against the insurer. (See Comment Article IV, Section 3c.) Evidence of insurability is required to protect against anti-selection. (See Comment Article IV, Section 3c.)

Paragraph (8) is intended to prevent a policyholder from borrowing amounts which are so small as to generate high costs in administering the loan by the insurer with limited corresponding benefits to the policyholder. Of course, the Commissioner must ultimately determine what will constitute a reasonable minimum amount.

Paragraph (9) is self-explanatory.

Paragraph (10) permits as a contractual matter, a provision for partial surrender. During the deliberations of the Subcommittee at least one insurer intended to offer only a partial surrender provision with no policy loan. The Subcommittee clearly determined that a partial surrender could be offered but only in addition to the policy loan or partial loan provisions previously described. This Paragraph requires that the policy must clearly indicate that the policyholder has the option of exercising either partial surrender provision or the policy loan/partial withdrawal privilege. It requires proportionate reduction of both variable and minimum death benefits in accordance with the proportion of current cash value received by the policyholder. An insurer is allowed to adjust premiums for the remaining amount of insurance to those which are appropriate for the lower amount. This is to permit the insurer to offset its possible loss of economies which result from higher policy denominations. The policy may provide that this surrender privilege will not require the insurer to reduce the policy issued upon partial surrender to an amount of minimum death benefit below the lowest amount of minimum death benefits which would have been available from that insurer at the time the original policy was issued.

Paragraphs (11) and (12) must be read together. They were inserted in order to attempt to solve problems which have long been associated with fixed benefit policy loans.

In participating fixed benefit life insurance policyholders who borrow at favorable interest rates reduce the overall income to the insurer as a whole. This reduction is reflected in reduced dividends to all policyholders. Thus, the nonborrowing policyholder is hurt in two ways: (1) not taking advantage of potentially favorable interest rates and (2) reduction of dividends for the benefit of those who do take advantage of such rates. The Subcommittee was especially aware of this problem in view of the economic climate in which the regulation was drafted. Fortunately, the nature of variable life insurance provided at least one opportunity of which the Subcommittee was aware, to remedy this situation and resulted in Paragraphs (11) and (12).

The NAIC model regulation does not specify any particular method of making policy loans. It does, however, specifically require in Article IV, Section 4(b)(11) that the insurer shall construct policy loan provisions so that all policyholders (variable and fixed) of the insurer who have not exercised policy loan provisions are not disadvantaged by the exercise of such loan provisions by other policyholders. There is no restriction as to how companies shall accomplish this result.

One method which is likely to be utilized requires the transfer of policyholder loans from the separate to the general account (again illustrating the constant interrelationship of the two) and blending of the different (variable and fixed) rates of net investment return earned by the "policyholder" taking the loan. As a result, only the variable life insurance policyholders actually taking policy loans receive a net investment return based on the policy loan rate on that portion. The return to nonborrowing policyholders (both variable and fixed) is unchanged. It was suggested by some, however, that loans should be required to be made from the insurer's general account since transfer of the loan amount from the separate account might, depending upon that account's investment performance, decrease the return to borrowing variable life insurance policyholders. This approach reflected little concern over the fact that such a provision would require the insurer's fixed benefit policyholders to subsidize the borrowing variable life policyholders, and further that the risk of poor return was no longer imposed on the borrowing policyholder, and was rejected for that reason.

This aforementioned approach, in effect, applies the difference between the net investment return based on the policy loan interest rate and the net investment return of the separate account against the policy loan indebtedness to adjust the benefits otherwise payable. Under this approach, the borrowing variable life policyholders will be credited with a net investment return based on the policy loan interest rate rather than the separate account net investment return for the purpose of calculating policy benefits. Thus, to the extent of the loan borrowing, variable life insurance policyholders have a policy which is totally insulated from both favorable and unfavorable separate account performance, and nonborrowing policyholders remain unaffected. Borrowing policyholders are affected only to the extent of their loans.

The question of whether Paragraph (12) requires a mutual insurance company to carry policy loans as assets of the separate account has been a source of some confusion within the insurance industry. One possible method of achieving the result required by Article IV, Section 4(b)(11) and (12) would be to withdraw the amount of the policy loan from a separate account, to hold the loan indebtedness as a general account asset and in order to keep both the general account and separate account in balance, to transfer to the general account a portion of the variable life insurance reserve liability equal to the indebtedness.

Another possible method to achieve the same result would be to determine separately, the investment return (within the separate account) on policy loan assets, and on the remaining assets exclusive of policy loans.

The blended return described above would be achieved under either approach. Under both approaches the monies actually paid to policyholders upon making a policy loan would be withdrawn from the separate account as required by this Section. The only difference is that in one case separate account assets and liabilities are balanced by transferring a portion of the reserve liability to the general account while in the second case the balance is maintained by substituting a policy loan asset in the separate account to replace the cash asset which was withdrawn. There was no specific intention by the Subcommittee in drafting Section 4(b)(12) to require the holding of loan indebtedness as a general account or separate account asset, therefore, since the results obtained by either course would be the same either one would seem to be permissible. Naturally, regardless of which procedure were followed, it would be necessary to comply with Article IV, Section 4(b)(11).

The Subcommittee did not intend the transfer of policy loan indebtedness to the general account to be precluded by Article VI, Section 7a.

Since the shareholders and not the policyholders of a stock company will be taking the risks of decreased return if a loan is made from the general account, Paragraph (12) allows stock companies to make loans from their general account.

Section 5 – Other Policy Provisions

SOURCE: Subsections a, d, and most of c are based on standard fixed benefit life insurance policy provisions.

COMMENT: The requirements of this Section are optional. However, if provisions are made they must resemble in substance the mandates of this Section.

Subsection a allows a two-year suicide clause. Of course, the clause must be in conformity with applicable state law.

Subsection b permits the offering of incidental insurance benefits. (See Article II, Section 8.) If such benefits are offered, they must be on a fixed basis only. (See Comment to Article IV, Sections 1c and 2a.)

Subsection c deals with policy dividends. If the policy is participating, it must offer dividends in cash. In addition or in combination therewith, the policy may provide the dividend options enumerated in Paragraphs (1) through (6). As noted in the Comment to Article IV, Section 2c, if dividends are used to "purchase" additional insurance under 5c(2) or (3), the amount payable on death will equal the greater of the minimum death benefit or the variable death benefit (adjusted by indebtedness) plus the benefit resulting from the dividend "purchased" paid-up addition.

The rationale underlying Paragraph (6) is the same as expressed in the Comments to Article IV, Sections 1c and 2a.

Subsection d allows for an insurer to offer an automatic premium loan provision on an optional basis. The policyholder must elect its use in writing either in the application or later. If offered, the loan must be on a basis at least as favorable to the policyholder as Article IV, Section 4b. The language which allows the imposition of a two premium limitation is for the policyholders benefit in order to prevent a previously applied for automatic premium loan from destroying cash values without the policyholder being aware of this occurrence. If the policyholder renews his request for the automatic premium loan, the two premium period should commence running anew.

ARTICLE V: RESERVE LIABILITIES FOR VARIABLE LIFE INSURANCE

SOURCE: 1 NAIC Proceedings 1973 p. 304.

COMMENT: Section 1 refers to reserve liabilities arising from variable benefits and requires their being held in the separate account and determined on a basis consistent with the Standard Valuation Law.

The Standard Valuation Law is prospective in nature and requires a knowledge of future benefits. Since under variable life insurance future benefits are unknown, this Section recognizes that the Standard Valuation Law cannot be applied without appropriate modifications. Thus, this Section requires the application of the principles contained in the Standard Valuation Law in a manner which is actuarially consistent with the variable nature of the benefits provided.

Section 2 deals with the reserves for the minimum death benefit guarantee. (See Article II, Section 10 and Article IV, Section 2c.) This Section was adopted by the Subcommittee in substance in December of 1972. The following Comments provide an explanation of this Section and are drawn from the Subcommittee's report at that time.

The purpose of the reserve for the minimum death benefit guarantee (MDBG) is to accumulate funds to provide for the contingency of death occurring when the guaranteed minimum death benefit exceeds the death benefit that would have been payable in the absence of such a guarantee. The amount payable under the minimum death benefit guarantee, as referred to below, means the excess of the minimum death benefit over the death benefit that would have been payable if there were not such guarantee. The reserve for the minimum death benefit (MDBG reserve) means the reserve for such excess death benefit. The amount payable under the minimum death benefit guarantee tends to increase if the investment earnings on the assets of the separate account funding the contract are less than the assumed investment return for the contract and vice versa.

Taking into account the purpose of the MDBG reserve and the nature of the minimum death benefit guarantee, the Subcommittee concluded that the acceptable MDBG reserve system should have the following characteristics:

1. The MDBG reserve should be held in the general account of the company so that it will be backed by the general assets of the company, most of which are debt obligations valued at amortized cost and, therefore, are of a fixed dollar nature. It would not be proper to hold the MDBG reserve in the separate account since the reserve would not be supported by fixed dollar assets but by assets that are moving in the opposite direction from the risk, i.e., were moving downward when the risk is increasing and vice versa.

2. The MDBG reserve should be adequate to cover, under all but the most extreme circumstances, the MDBG death claims for the next year, so that the regulatory authorities can be assured the company will not run into financial trouble from this source before the next annual statement is filed.

3. The MDBG reserve should react slowly but steadily to an extended period of poor investment experience of the separate account.

4. The MDBG reserve should not overreact and cause unnecessary fluctuations in surplus by increasing too rapidly in a sharp market downswing. Also, the reserve should not decrease too rapidly in a sharp market upswing after a period of poor market experience.

5. The reserve should be subject to the same valuation standards with respect to mortality and interest as any other life insurance reserve, currently the 1958 CSO mortality table and a rate of interest not in excess of three and one half percent, and should not be discounted by rates of withdrawal because of their uncertain nature and the great variation in such rates between one company and another. Withdrawal rates are particularly uncertain for variable life insurance since no U. S. companies have yet written such insurance.

After extensively testing the operation of many proposed reserve systems against these criteria under various assumptions as to the investment performance of the separate account, the Subcommittee decided to recommend a three-part MDBG reserve system, consiting of (1) an accumulation of amounts allocated by the insurer to the MDBG reserve, less actual MDBG claims paid, subject to a two-part minimum equal to the greater of, (2) a one-year term reserve to assure coverage of next year's claims, and (3) a reserve designed to protect against an extended period of poor investment experience of the separate account.

The amounts allocated by the insurer to the first part of the reserve system depend upon the design characteristics of an insurer's variable life insurance contract, the insurer's judgment of the risk it has assumed, and its assessment of the possible impact on its surplus of future changes in the two-part minimum.

The second part of the reserve system is a requirement that the reserve be sufficient to cover all MDBG claims of the following year if there is an immediate one-third depreciation in the value of the separate account assets.

The third part of the reserve system forces an insurer to gradually increase its reserve if this is necessary to cover MDBG claims arising from an extended period of poor investment performance. The technique used is to fund the cost of future MDBG claims by level payments over the future premium paying period of the contract.

The Subcommittee's proposal also provides that suitable approximations and estimates may be used to shorten the work of computing the reserve for the minimum death benefit guarantee.

The requirements for a reserve for the MDBG originally adopted by the NAIC (1 NAIC Proceedings 1973 p. 504) included a provision that amounts be regularly allocated by insurers to be accumulated to form a reserve which would be charged with any excess of actual death benefits paid over those which would have been paid in the absence of the MDBG.

This requirement was subsequently deleted from the model regulation because of the difficulty of specifying the amounts to be regularly allocated since such amounts vary depending on factors such as the plan design and the assumed investment return. The Subcommittee felt that it would be better for companies to include in their plan of operations (see Article III, Section 1c1) a specification of the amounts to be regularly allocated for this purpose.

The reserves for the minimum death benefit guarantee were adopted on an interim basis are intended to be reviewed periodically to insure their satisfactory operation.

Section 3 requires the application of the Standard Valuation Law to incidental insurance benefits.

ARTICLE VI: SEPARATE ACCOUNTS

COMMENT: Totally aside from the model, any matter which might pertain to the insurer's ability to perform its obligations within a particular state is always subject to the scrutiny and regulation of the Commissioner of that State. Thus, the Commissioner of any State can always change his regulations and/or bar an insurer from doing business in his state as well as invoking all other enforcement remedies available to him. However, as a general proposition, the internal management of the insurer is normally regulated by the state of domicile, and in the absence of unusual circumstances, this regulation is accepted by the other states in which the insurer does business. In fact, this is the reason underlying Article III, Sections 1b, 1c(3)(C), and 2e.

Article VI deals generally with separate account operations and the management of the insurer. Therefore, within the above context it was expected that conduct under this Article would primarily be regulated by the state of domicile.

Section 1 – Establishment and Administration of Separate Accounts

SOURCE: This Subsection is new except for the Introductory Paragraph which is drawn from Article IV of the NAIC Model Variable Contracts Regulation. In addition, Subsection b is derived from Section 9 of the Investment Company Act, Section 15b(5)(B) of the Securities Exchange Act and Section 203(e) of the Investment Advisers Act.

COMMENT: This Section relates to the creation of separate accounts. Subsections a - c relate to custodianship, bonding requirements, and the background of persons associated with the material handling of separate account assets.

It is important to note in any discussion of these areas that the assets of the separate account are only significant with respect to solvency. Unlike a mutual fund in which the shareholder owns a proportionate share in the assets that exist, the variable life insurance policyholder owns the right to be paid benefits according to the contract, regardless of whether the assets underlying the policy actually exist. In this regard the Commissioner's sole concern as to the existence of assets is limited to solvency. The insuer's obligation exists regardless of whether or not the assets have been stolen. Misconduct has no effect on the determination of benefits owed to the policyholders. (See also Comments to Article IV, Section 2a.) Therefore, the interest of the Commissioner with respect to misappropriation is exactly the same for fixed benefit and variable life insurance – namely, the ability to pay benefits under the policy.

Subsection a relates to custody of separate account assets. The laws of some states are quite specific in this regard (see e.g., Kansas Insurance Law Section 40-404 and Iowa Insurance Law Section 511.8(6)) and were intended to govern over this provision. (See e.g., CCH Federal Securities Law Report, Paragraph 77,808 at p. 83,875.) In the normal instance the Subcommittee certainly expected that the insurer would maintain custody over its assets including those allocated to its separate account. In this context it was recognized that an insurer is never really acting as custodian of separate account assets.

Since a variable life insurance separate account is an integral part of the insurer, the insurer is acting as "custodian" (really owner) of its own assets, including those which it may have internally allocated to the separate account. Neither the "separate" account nor the variable life insurance policyholders own any assets. As a matter of fact, the Model Variable Contract Law Section 1(e) provides that "amounts allocated to a separate account in the exercise of the power granted by this Act shall be owned by the company, and the company shall not be, nor hold itself out to be, a trustee with respect to such amounts."

An affiliate of the insurer holding custody of the insurer's assets would not be the same thing as the insurer itself holding them. Clearly, assuming no contradictory requirement, the model regulation would require approval by the Commissioner of the state of domicile. The standards to be reviewed would presumably be (1) safety of the assets; (2) cost; and (3) the absence of a conflict of interest which might be detrimental to the policyholders.

Subsection b requires the prior written approval of the Commissioner in order for an insurer to employ the persons described therein in any "material" capacity with the handling of assets allocated to the separate account. As noted earlier, this is primarily a solvency concern. However, because the assets underlying variable life insurance separate accounts are inherently liquid in nature, they are more easily converted and this Subsection was felt to be desirable.

The term "material," as it is used in this Subsection, is designed to cover any person who is employed in a position which would enable misappropriation of funds. It was the Subcommittee's understanding at the time the model regulation was drafted that to consent to an injunction would be an acknowledgement of a violation and, therefore, approval would be required under this Section. The prohibition of this Section would not define a narrower class of persons than are covered under the Investment Company Act.

As previously discussed, since the operations of the separate account would generally be regulated only by the state of domicile, approval under this Section would not necessarily have to be obtained in every jurisdiction in which a company proposed to sell variable life insurance. However, the provisions of Article III, Section 1c would still be applicable.

Drafting Note 12 was inserted because of the possibility in some states of laws or administrative rulings which do not allow employment discrimination against those who might not qualify under this Subsection. It should be noted that this provision does not prohibit employment of those described herein. Rather the insurer must notify the Commissioner who must determine the public interest in each particular case.

Subsection c refers to bonding requirements for persons with access to separate account assets. Since bonding is not uncommon in state insurance regulation, the Subcommittee determined to leave the particular amount to each particular state. Thus far, the most definitive bonding standards yet developed for purposes of the model regulation are those of California. They are reproduced below:

TOTAL ASSETS		MINIMUM AMOUNT OF BOND
Under $100,000		$10,000
More Than:	But Not More Than:	
$ 100,000	$ 600,000	$10,000 plus 4% of assets over $100,000
600,000	1,200,000	$30,000 plus 3-1/3% of assets over $600,000
1,200,000	3,200,000	$50,000 plus 2-1/2% of assets over $1,200,000
3,200,000	4,450,000	$100,000 plus 2% of assets over $3,200,000
4,450,000	6,450,000	$125,000 plus 1-1/4% of assets over $4,450,000
6,450,000	90,450,000	$150,000 plus 5/8% of assets over $6,450,000
90,450,000	350,450,000	$675,000 plus 3/8% of assets over $90,450,000
350,450,000	1,070,450,000	$1,625,000 plus 3/16% of assets over $350,450,000
1,070,450,000	—	$3,075,000 plus 3/32% of assets over $1,070,450,000 until total bond equals $5,000,000

Subsection d recognized the legitimacy in some instances of establishing more than one variable life insurance separate account. This might be for different investment objectives, etc. However, the Subcommittee was concerned with the possibility of an insurer creating two smaller separate accounts in order to deduct a greater total amount pursuant to Article IV, Section 7a. (See Article VI, Section 7b.) Thus, creation for this purpose is prohibited, and the insurer must file its justification for the creation of additional accounts with the Commissioner. (See Comment Article III, Section 6d.) Such creation is subject to the approval of the Commissioner.

Subsection e should be read in conjunction with Article IV, Sections 2g and h as well as Section 3e(3).

The model regulation allows annual death benefit determination and monthly cash value determination. However, each can be determined much more frequently (daily is a common variation). Allowing cash value determination which was less frequent than monthly combined with "backward" valuation (see Comment to Article IV, Section 2h) would have exposed the insurer to great speculation risks and could affect solvency. Therefore, monthly cash value determination was required. Since it would be impossible to determine benefits without valuing assets this Section merely restates the obvious in requiring asset valuation at least as frequently as benefits are determined.

The Comments to Article IV, Sections 1c and 2a explain the thinking behind Subsections f and g.

Section 2 – Amounts in the Separate Account

The valuation reserves underlying the variable portion of the policy measure the amount of current liabilities arising from the obligation to pay future variable benefits. Thus, Subsection a requires corresponding assets to be maintained in the separate account for solvency reasons since the required reserve will fluctuate in direct response to changes in variable benefits. (See Article V, Section 1.)

Assets at least equal to the benefit base must be maintained in the separate account in order to assure that sufficient excess investment return exists to provide the benefits required by Article IV, Sections 2e and 2f. The reference to the "valuation reserves for the variable portion of the policy" is not intended to encompass reserves for fixed nonforfeiture benefits, reserves either for dividend accumulations or for dividends applied to purchase paid-up insurance, or reserves for incidental insurance benefits.

In computing the "benefit base" pursuant to Subsection b, the terms "valuation net premium" and "valuation terminal reserve" should be interpreted to apply only to the variable portion of the policy and should not be interpreted to apply to any fixed benefits provided by the policy or riders attached thereto. States wishing to make this interpretation explicit in the language of the regulation may do so by inserting the words "for the variable portion of the policy" after the word "period" in the first line of Subparagraph b(1) and after the word "reserve" in the first line of Subparagraph b(2).

The minimum benefit base at the beginning of any valuation period depends, in part, on the terminal reserve at the end of the preceding period. It is important that this terminal reserve be adjusted for the net investment return of the preceding period. As drafted, the Section does not specifically require this adjustment. However, it was intended to do so. Instead, it literally requires that the terminal reserve be "based upon the amount insured at the end of such [preceding] period." This would give a correct result for some types of variable life insurance policy designs, but for other types the result would be either too small or too large, depending what the net investment return had been. Also, if the policy were in force under a reduced variable paid-up nonforfeiture option, the minimum benefit base should not depend on a valuation net premium "based upon the initial amount insured."

The benefit base described in this Section refers to the benefit base while the policy is premium paying. It is assumed that the benefit base while the policy is operating under any reduced paid-up variable nonforfeiture option will equal the amount as defined in Paragraph 2 of this Section, less the amount of any indebtedness.

Any comparison of the values of differing patterns of benefits under life insurance policies will necessarily involve actuarial assumptions. Values would be "substantially equivalent" under Subsection c if they were demonstrated to be equivalent under reasonable and appropriate actuarial assumptions. The test of this Subsection applies to the benefits over a twenty-year period and not solely to the benefits at the end of the twenty years. Benefits can be equivalent over twenty years, but not identical in each particular year under the specified benefit base if some benefits are higher and other benefits are correspondingly lower, or if the differences are insubstantial. The Subcommittee expected that a demonstration under this Section would be based on a computation of the present value of death benefits over the twenty-year period as compared to the present values required under Section 2b using appropriate actuarial assumptions. In any event, the difference would have to be relatively small in order to satisfy this Section.

Subsection d permits, for the time being, the insurer to offer the same benefits for substandard risks.

(See Comment to Article II, Section 4.)

Section 3 – Investments by the Separate Account

SOURCE: Subsection a is from the original Model Variable Contracts regulation. Subsections b and c are new.

COMMENT: For various reasons the Subcommittee was concerned over the valuation of separate account assets. First, these assets form the basis for most of the reserves underlying the policy's benefits. Proper valuation is essential to assure solvency. Second, the separate account serves as the measure by which investment performance and, therefore, ultimately policy benefits are determined. Consequently, the model regulation must balance sometimes competing concerns, i.e., assuring that the insurer does not artificially inflate the appearance of its investment performance by initially undervaluing its separate account assets (and thus the basis on which investment return is calculated) vis-a-vis the traditional insurance view of conservatively valuing assets in order to assure that the insurer can meet its obligations to the policyholders.

With variable life insurance this traditional concern assumes special significance because of the interrelationship between the separate account and the insurer's general account and the resultant possibility that the general account (and indirectly the insurer's fixed benefit policyholders) will be forced to backstop any significant undervaluation to the extent of the initial face value guarantee. On the other hand, too high an initial valuation will tend to artificially deflate investment performance and, therefore, inadequately credit variable policy benefits. Thus, in establishing valuation requirements, the Subcommittee sought to balance these potentially competing concerns and to minimize the potential for insurer manipulation.

The Subcommittee had to be sure that valuation methods were appropriate to the nature of variable life insurance and the need to protect all – not just variable – policyholders.

Thus, partially in order to preclude an insurer from improperly valuing separate account assets, separate account investments are limited by the model regulation to those investments which have a "reasonably ascertainable market price." The only permissible investment types are specifically enumerated. In addition, investment types which lack readily available market values (e.g., real estate, otherthan "listed" real estate investment trusts) or those which are inconsistent with the life insurance nature of variable life insurance (e.g., commodities) are specifically prohibited.

While the Model Variable Contract Law Section 1b exempts insurers from traditional state investment restrictions, the limitations of Section 3 of the same law give the Commissioner authority to prevent the issuance of policies which will render the insurer's operation hazardous to the public or its policyholders. The restrictions of this Section are based on this Section as well as Section 4 of the Model Variable Contracts Law. (See also Section 1c of the Model Law.)

The provisions of Subsection a are common to many existing statutes and regulations and are intended to prevent unfair or discriminatory transfers between accounts. Regular cash flow should permit those transfers to and from the general account necessary to the operation of the insurer's variable life insurance business to be made in cash.

The introductory language to this Subsection recognizes that the separate account is not a separate entity and is not an affiliate of the insurer. Therefore, the transactions covered by this Section include those between: (1) the general account and the separate account, (2) one separate account of the insurer to another, and (3) an affiliate of the insurer to either the general or a separate account.

Paragraph (1) recognizes the need of "seed" money to establish a separate account of adequate minimum size and further the need for the constant periodic flow of cash in the form of the valuation net premium from the general account to the separate account to support the operation of policies.

This interaction can be graphically illustrated as follows. (See also Article VI, Section 7.)

Paragraph (2) presumes that all transfers will be in cash. However, it permits transfers of assets other than cash if approved by the Commissioner in advance. A transaction which is fair and equitable to both variable and fixed benefit policyholders is, of course, the standard which must be applied in determining approval. Naturally, assets transferred into the separate account must satisfy the requirements of Subsections b and c.

This Section does not permit interest bearing loans by the general account to the separate account to establish the latter. (See Article VI, Section 3b and Article VI, Section 9.) Article IV, Section 2e makes no provision for allocating separate account earnings to amortize any indebtedness.

Subsection b defines the only investments which are permissible for the time being. It contains "investments" which both possess a reasonably "ascertainable market price," and certain minimum qualitative standards which denote investments which are consistent with the life insurance nature of variable life insurance. The Subcommittee specifically rejected an industry proposal which would have permitted "additional investments authorized, specifically or by class or otherwise, by the Commissioner," in order to promote uniformity. (See Article III, Section 16.)

Paragraph (1) was inserted to indicate that policy loans were permitted. (See Comment to Article IV, Section 4b.) Paragraphs (2), (3), and (5) are self-explanatory.

Clearly, Paragraph (4) permits the insurer to invest in the shares of one or a number of mutual funds, as long as the requirements of Article VI, Section 4 are complied with. In addition, of course, the mutual fund itself must comply with the restrictions or Article IV, Sections 3 and 4. (See Article IV, Section 4c.)

It was the intention of the Subcommittee that investment in load mutual funds would be regulated by Article VI, Section 7a(4). While investment in a load fund would not be prohibited, it would be quite severely restricted by this Section, since it was intended that a sales load would be an "investment management (not advisory) expense" under 7a(4) and not a "direct acquisition cost" under 7a(2). Thus, the .75% maximum limitation would have to include any mutual fund sales load.

The model regulation does not require that a mutual fund guarantee that its advisory fee will not exceed the limits of Article IV, Section 7a. However, the insurer may well wish to obtain some such assurance. Furthermore, the existence or nonexistence of such an assurance might well be a consideration of the Commissioner pursuant to Article III, Section 1c(1).

There was some debate over whether or not commercial paper should be a permitted investment. The Subcommittee finally determined to allow such an investment but only after inserting the qualitative standard imposed by Paragraph (6). Commercial paper has been defined as "short term unsecured notes issued for cash by the corporation, generally supported in whole or part by outstanding lines of credit extended by financial institutions" (Investment Company Act Release 8082, Accounting Series Release Number 148 November 13, 1973). It is customary for a company issuing commercial paper to obtain a bank line of credit as a sort of collateral for the paper. The Subcommittee was aware that in the case of certain large issuers that such a line of credit may not be available since the total paper issued may exceed the legal limit of bank loans. In spite of this, the Subcommittee determined to impose this restriction. In any event, this Paragraph states that commercial paper is permitted as an investment only if the total paper issued by a company does not exceed the value the lines of credit extended thereon.

Paragraphs (7) and (8) are self-explanatory.

Subsection c lists investments which are not permissible either because they were deemed to be so inherently speculative as to constitute improper life insurance investments, or those which were incapable of being uniformly valued (e.g., real estate).

At the time the model regulation was drafted, the Subcommittee considered the possibility that some insurers might wish to make their variable life insurance separate accounts available for participation by other insurers desiring to get into the variable life insurance business. The Subcommittee by this Section clearly determined to prohibit such an arrangement by Paragraph (6) unless a registered investment company were involved.

Section 4 – Limitations on Ownership

SOURCE: Subsections a and b are derived from the NAIC Model Variable Contracts Regulation Subsection. Subsection c is new.

COMMENT: Subsection a provides that separate accounts cannot "purchase" or otherwise acquire shares in any one issuer (other than the United States) if such acquisition would result in investments in that insurer exceeding 10% of the value of assets allocated to the separate account. This quantitative limitation is imposed to promote diversification and limit investment risk. The Commissioner is given authority to waive this restriction in unusual circumstances where such waiver is found not to be hazardous to the public or the policyholders.

Subsection b prohibits the acquisition of the securities of an insurer if such acquisition would result in the insurer's ownership of more than 10% of the voting securities of such issuer. (See Article II, Section 6.) As in Subsection a, the Commissioner may waive this condition where such waiver is found not to be hazardous to the public or the policyholders. However, in addition, a waiver under this Subsection must also be based on an affirmative finding that the independent operation of the issuer will not be jeopardized. This may be especially important with respect to Article VI, Section 3b(4). In this regard coordination with the SEC may be desirable.

Subsection c was inserted in order to assure that this Subsection a would not preclude investment in mutual fund shares, so long as the mutual fund complied with the investment restrictions of Article VI, Section 3 (and 4) as well as all other applicable portions of the regulation.

Section 5 – Valuation of Assets of a Variable Life Insurance Separate Account

SOURCE: New

COMMENT: The Subcommittee was concerned with uniform portfolio valuation for a number of reasons.

A particular security may be held by separate accounts and by life company general accounts. When this situation occurs, the NAIC will value the security for general account purposes.

It would appear unreasonable for the same security, held by several different variable life insurance separate accounts, to have different values. Only uniform NAIC valuation can avoid this result.

The Insurance Commissioners have a vital interest in the values given assets in the separate account because of the impact on the solvency of the general account cause by minimum guaranteed death benefit. In fact, it can be argued that the Commissioner's interest equals that of the variable life policyholders. Thus, it is important that the Commissioner be satisfied with the values given the separate account assets.

Death benefits and cash values will depend to some degree on the investment performance of the separate account. Clearly, in the absence of regulation a company could change its valuation procedures to alter the separate account investment results, either up or down.

The Subcommittee attacked its concerns in two ways: (1) limiting investments to those which had a readily ascertainable market price (see Comment to Article VI, Section 3b) and (2) the valuation provisions of this Section. The Subcommittee would have been much more likely to permit investments in things such as real estate or mortgages had there been a workable uniform valuation method available.

Subsection a requires no further explanation.

Subsection b applies in those instances where a permitted investment ceases to be traded and, therefore, despite the intentions of the regulation's drafters, no longer possessed a "reasonably ascertainable market price." In this instance the investment must be valued in good faith by or at the direction of the insurer's board of directors.

Thus, this responsibility is clearly placed on the board. (See Article VI, Sections 9a and 8.) The valuation by the board can under no circumstances be in excess of the last reported bid quotation. Within thirty days of cessation of trading, the insurer must notify the Commissioner of the insurer's state of domicile who must, within a reasonable period of time, determine the valuation of the investment as well as its disposition or retention. It is anticipated that such valuations would be carried out with the assistance of the NAIC Valuation of Securities Office.

For the purposes of this Subsection, "cessation of trading" is not merely the absence of market activity but rather a suspension of trading by the applicable market, exchange, or regulatory agency.

The valuation of investments could confront the insurer's management with the obligation of balancing interests. A higher valuation might mean increased contract benefits whereas lower valuation could require a greater insufficiency reserve.

However, the "conflict" would not involve benefiting the insurer at the expense of the policyholders but rather would involve benefiting one class of policyholders over another. There is no feasible way for the insurer to determine in advance whether it would benefit a higher or lower valuation. The practical result is that the board would have no motivation to do anything other than to assign the fairest possible value with, of course, the continuing oversight of the Commissioner for added incentive and protection.

The use of a valuation which proves to be higher than the value determined when trading of the security resumes will have different effects on various policyholders. Most -- but not necessarily all -- of the policyholders who surrendered previously issued policies during that period would benefit. The death benefits under some policies -- possibly a very small portion or possibly a substantial majority – would be unaffected. Where the death benefits were affected, most of the beneficiaries – but not necessarily all – would benefit. For persons who purchased new policies while the security was not being traded, death benefits and cash values might be higher or lower while the suspension of trading continued, but would generally be lower after trading resumed than they would have been if a lower price had been assigned to the security.

The effects would be very mixed, however, on the substantial body of policies which continued in force throughout the period during which the security was not traded. If the aggregate separate account assets were to increased over this period, regardless of the cause of the increase, continuing policies would tend to benefit from a high valuation of the untraded security. This is because the dollars "lost" on the security would produce less of a reduction in the rate of net investment return if they were recognized when the total separate account assets were higher. On the other hand, if the benefit base of an individual policy were to increase over this period, regardless of the cause of the increase, that continuing policy would tend to be disadvantaged by the high valuation. This is because a given reduction in the rate of net investment return will have a greater impact on a policy with a large benefit base than on a policy with a small benefit base.

Since both the aggregate separate account assets and the benefit bases of individual policies will change during the interim period, the net result is likely to be favorable to some continuing policyholders and unfavorable to others. Moreover, for some continuing policyholders the net result could be higher death benefits but lower cash values, or conversely, because a given change in net investment return will not have the same proportionate effect on cash values as on death benefits at different times in the life ofthe policy. Whether or not continuing policies in the aggregate would benefit or be disadvantaged would depend on a variety of factors, including the separate account investment performance, the separate account cash flow, and the mix of issue ages, policy durations and plans of insurance of the continuing policyholders.

The effects of too low a valuation would be the opposite of those described above. In either case, the insurer would lose money to the extent that all policyholders in the aggregate benefited. But as is clearly evident, even an elaborate and expensive analysis of the business would not clearly demonstrate whether a high or a low valuation would be in the company's interest, since the aggregate results will depend on other factors during the interim period which are unpredictable.

A lower valuation could, of course, require the insurer to establish larger reserves for minimum death benefit guarantees in accordance with Article V, Section 2 of the Model Regulation. The size of the reserve does not affect the insurer's actual profitability, however; it merely affects the timing with which profits are recognized according to the annual statement prescribed by the NAIC. This reserve is, therefore, unlikely to be a significant factor, except in the unlikely circumstances where both (a) the variable death benefit is close to or below the minimum death benefit for many policies and (b) the insurer is otherwise dangerously close to becoming involvent.

The standards by which valuation must be made are clearly those of good faith and fair market value as determined by the board with the oversight of the Commissioner. The NAIC Valuation of Securities Office produces detailed manuals for the valuation of investments. Furthermore, the Standards of Conduct in Article VI, Section 8 and the conflicts of interest provisions ofArticle IV, Section 9 would be applicable here. The board, subject to the provisions of this Section, the direction of the Commissioner, and the standards established by the Valuation of Securities Office could make a good faith valuation with respect to portfolio securities which cannot be readily valued with respect to recent trades.

The Commissioner's general oversight of portfolio valuation is not limited to securities which have ceased to be traded. He can and must always have the power to revalue. Clearly, the interests of both fixed and variable policyholders would be the standard which would be applied to determine the appropriate method of valuation or disposition of a security pursuant to this Section.

Section 6 – Separate Account Investment Policy

SOURCE: New

COMMENT: The Model Regulation was drafted in an atmosphere of conflicting regulatory jurisdiction claims. There was concern by both the (C4) Subcommittee and the SEC over unauthorized changes in investment policy. In view of this situation, before dealing with the specifics of this Section, it is instructive to review the potential application of securities law concepts to this concern and explain why such approaches were rejected.

Under the Investment Company Act of 1940, a security holder of an investment company has a right to vote upon proposed changes in investment policy. Such a provision, however, was found to be inappropriate in the context of variable life insurance. The Model Regulation has developed what is felt to be more meaningful protection in this area which must consider not only the interests of the variable life insurance policyholders but also those of other policyholders of the issuing company. This stems from the fundamental interrelationship between the separate account and the rest of the insurer's operations.

The operation of a separate account which funds variable life insurance intimately relates to and impacts upon the general account of the insurer. An insufficiency reserve must be established in the general account to provide for the contingency that separate account assets may be less than that needed to support the guaranteed minimum death benefit (initial face value). Furthermore, general account reserves must be established to support all other policy benefits. In the event the combination of the reserves in the general account prove inadequate, the surplus of the insurer stands behind the variable as well as fixed dollar life policyholders.

A separate account is basically an accounting mechanism to measure the level of benefits the insurer owes to its variable life insurance policyholders. Unlike in a mutual fund, the insured or beneficiary does not own and the insurer's obligations are not limited to the separate account assets. All assets of the company, not just those underlying the separate account, stand behind the insurer's total obligation including the mortality and expense guarantees and the guaranteed minimum death benefit. In fact, some do not understand that the concept of proportionate ownership crucial to the regulatory philosophy of the Investment Company Act is not only foreign to but inherently contradictory to the insurance concepts of pooling risks underlying variable as well as all other life insurance. Consequently, state insurance regulators have the responsibility to examine closely the investment practices and management of both the separate and general accounts and, where necessary, step in to protect the policyholders.

The unitary nature of variable life insurance is inherently contradictory to the mistaken concept that the separate account is severable from the insurer so as to be a distinct investment company under the 1940 Act. As a consequence, the 1940 Act requirement that security holders have voting rights over changes in investment policy can have no application to a life insurance company which has undertaken a contractual obligation to pay a death benefit. Requiring the insurer to turn over its separate account assets to a manager chosen by the purchasers of variable life insurance while the company's general assets are still at risk would conflict with insurance regulator's responsibility to all policyholders of the insurer. In short, an insurance regulator cannot permit one group of policyholders to be the ultimate arbiter of investment policies that can have a profound impact on other policyholders as well as upon the financial integrity of the company as a whole.

The SEC has apparently recognized this:

> It would also have been difficult, for example, to apply certain provisions of the Act relating to shareholder voting. If the assets of the variable life insurance separate account become inadequate to support the minimum death benefit, state insurance regulation might require the deficiency to be made up from the insurance company's general account. Accordingly, there is a question whether an insurance company would be willing to maintain a separate account for variable life insurance if, because of contractholder voting, the insurance company could not be certain it would continue to supervise and manage the account's activities (Investment Company Act Release No. 8000, page 7).

In fixed benefit life insurance the insured is concerned about investment policy to the extent of a large portion of his dividends. In variable life insurance his benefits are determined as a result of investment performance. The Subcommittee felt that the policyholder should be entitled to a continuation of theinvestment policy upon which he relied in purchasing the policy. (See Article VII, Section 2a.) Thus, at the opposite end of the spectrum from voting rights, the Subcommittee considered at one time refusing to permit any changes in investment policy for existing policyholders. In view of the whole life nature of the policy (see Article IV, Section 2a) this was considered to be too inflexible as long as a reasonable alternative could be found. The need for uniformity was imperative and was solved by Article III, Section 1b.

While rejecting "voting rights" the Subcommittee feels that the Model Regulation recognizes the necessity that variable life insurance policyholders be protected against undue changes in investment policy. To do so, the following procedure has been incorporated into the Model Regulation.

When any insurer proposes to change the investment policy upon which the policyholder had relied in the purchase of variable life insurance, it must notify the Commissioner of the insurer's state of domicile. The change would be submitted for his approval and if it is determined that such a change is "material," notification must be made to all existing policyholders as well as the Insurance Commissioners of all states in which the insurer issues variable life insurance. After a public hearing, the Commissioner can approve or deny the proposed change in investment policy only if he finds that it does not appear to be detrimental to the interest of the policyholders. This provides more meaningful protection to the policyholder than would the voting right approach since the proposed investment change is being reviewed by a person with the expertise and authority to make an objective determination. While the voting right approach may appear to provide protections in the securities field, the Subcommittee did not believe that management proposed changes in investment policy have, in fact, been rejected by mutual fund shareholder votes in a substantial number of ease. Thus, the Model Regulation, cognizant of the total responsibility of the insurance regulator, seeks to protect not only the variable life insurance policyholder, but the other policyholders of the company as well.

Furthermore, the model regulation guarantees the right of variable life insurance policyholders who object to a change in investment policy which is ultimately approved by the Commissioner, to continue their insurance protection by converting to a fixed insurance policy.

The determination of exactly what constitutes a material change in investment policy was intended to be flexible and depend upon the particular facts of each case. Statements of investment policy as explained in the Comment to Article VII, Section 2 provide guidance in this area.

As a general proposition, the persons requesting a proposed change in the investment policy would bear the burden of demonstrating that such change is "not detrimental to the interests of the policyholders." The questions of procedure and expenses in conducting the public hearing required by this Section would be covered by the applicable state administrative law and procedure. However, as a general proposition, it would be fair to say that those persons requesting the approval would share the expenses connected therewith.

Clearly, the "interests of policyholders" in Paragraph (2) refers to all policyholders of the insurer, both variable and fixed, since a change in investment policy materially affects all of them. This is yet a further demonstration of the integral nature of the separate account and its interrelated impact on the overall operations of the insurer.

Policyholders of the insurer could request the Commissioner to initiate a change of investment policy through the normal complaint mechanism. Realistically, however, the Subcommittee would not expect this approach to be frequently used.

The right of conversion granted pursuant to Article VI, Section 6b(5) extends only to material changes in investment policy. As a practical matter, the policyholder will not be aware of proposed nonmaterial changes. However, it is fully anticipated that the burden of demonstrating that the change in investment policy is not "material" would fall on the person proposing the change. It would be expected that the Commissioner would always lean toward considering a change to be "material" in cases which were not clear-cut, in order to invoke the protection of this Section.

Clearly, all objecting policyholders must be given the right to choose between the options described in Subparagraphs (A) and (B). Neither the insurer nor the Commissioner would be able to limit the conversion right to one or the other.

If the insurer did not offer a fixed benefit policy sufficient to satisfy the conversion rights of this Section, it must arrange to provide for one. (See Article III, Sections 1b and 1c(1) as well as Comment to Article IV, Section 3g.)

The conversion options were developed to apply to policies currently in force on a premium paying basis. It subsequently became apparent that problems might arise in applying this approach to policies no longer in a premium paying status. For example, if extended term insurance were in force, either option would permit a conversion to permanent insurance without evidence of insurability. If variable paid-up insurance were in force (either fully paid-up or under a nonforfeiture option), option (B) would permit conversion to a premium paying policy. If reduced fixed benefit paid-up insurance were in force, option (B) would similarly be inappropriate, while option (A) would appear to have no effect on the policy. Therefore, this Section may require amendment to limit its application to appropriate situations.

The date of conversion should be the date on which a request, therefore, is received by the insurer and the cash value should be based on the last preceding valuation date.

Section 7 – Deductions from the Separate Account

SOURCE: The Subcommittee's concern with cost comparison resulted in this Subsection. Early drafts of the Model Regulation contained a flat 1-1/2 percent "asset charge" against the assets allocated to the separate account. Various insurers intended to fund everything from premium taxes to investment management fees to brokerage fees to a substantial amount of profit from this source. "Charges" against investment income are not unusual in calculating fixed benefit life insurance dividends. Thus, it was not unreasonable to assume that such charges would appear in variable life insurance since they serve as a means to more equitably apportion some costs associated with the operation of the policy. However, for the reasons to be described, the Subcommittee determined to strictly regulate this area. However, this Section was not the result of any illusion that it would reduce the cost of variable life insurance, except perhaps though competition resulting from increased disclosure.

At the time of the early drafts of the Model Regulation, various insurers sought to impose a total asset charge of from .5% to over 2%. It was at this time that the Subcommittee noted the apparent relationship between premium levels and "asset charges" and determined to act. Not surprisingly, they found that insurers which had a high "charge" against the separate account could afford to set its premiums on a relatively low level.

It would be next to impossible for a prospective purchaser to determine the true comparative cost to him of a percentage charge against separate account assets. In other words, the difficulty of comparing the cost of a policy with high premiums and a low separate account charge with a policy with low premiums and a high charge would be formidable at best. The high premium policy might well be a better buy, all other things being equal. The premiums for a policy with high charges against the separate account may be almost deceptively low since much of the cost of the policy would be reflected only in the calculation of the net investment return. Further, a charge in excess of actual or reasonably estimated costs tends to discriminate against long duration policyholders as their cash values increase. In addition, high deductions from the separate account (as well as high assumed interest rates – see Article II, Section 3) tend to decrease the policy's ability to increase benefits while simultaneously increasing the chances of decreasing benefits and increasing the cost of the initial face value guarantee.

In light of these concerns the Subcommittee determined to impose severe limitations on these charges. The intention of this Section is to allow only those expenses which could be justified as more reasonably related to the operation of the separate account than to premium income and to require all other expenses to be derived from premiums.

The intention for and argument behind this limitation was in no way based on the assumption that by doing so the total cost of variable life insurance will in any way be reduced. The Subcommittee fully recognized that it will cost X dollars to run a policy of a given benefit design regardless of whether that money comes from the asset charge or the premium. It is recognized that less flexibility in the asset charge will force companies issuing variable life insurance to place more of their costs including profit in their premium. The theory is that the cost to the policyholder is much more visible in the premium than it is in an asset charge to which he finds it almost impossible to relate. The Subcommittee determined, in effect, that it is inherently misleading to show a low premium and a high asset charge. If, in fact, the premium for variable life insurance is forced realistically to the point where there may be an unreasonable relationship to the premiums for fixed life insurance, the policyholder is entitled to be able to see this relationship. The Subcommittee hoped that by setting "charges" at a very low level that the maximum charge would become, in effect, almost a universal charge and that cost differences would be reflected in premiums which were more easily comparable. With the strict limitation, variation would at least be reduced if not eliminated.

The items which are allowed as deductions are exclusive. For example, the Subcommittee specifically decided that premium taxes were not allowed to be charged against the separate account. However, as noted earlier, neither the transfers of the excess of assets allocated to the separate account over liabilities to the general account (Article IV, Section 3e(2)) nor the transfer of cash to the general account for policy loans (Article IV, Section 4b(12)) were intended to be precluded by this Section. They were considered to be transfers and not deductions.

Paragraph (1) would permit a deduction from the separate account for taxes or reserves for taxes attributable to investment gains or income attributable to the separate account. This Paragraph would permit this deduction for taxes in the early years even if, because of start-up expenses, such taxes would not likely be due for some years.

The amount of the deduction would have to satisfy the insurer's auditors as well as the Insurance Department Examiners as reasonable in light of the actual tax circumstances of the insurer. Naturally, the amounts deducted would have to be held in reserve specifically for this purpose. If the auditors or the examiners determined that the amount reserved became excessive, future deductions would be required to be reduced until the reserve became reasonable.

Any excess would not be returned to those who were policyholders at the time of deduction since they never had any ownership rights to such funds. There is a possibility that policy benefits did not accurately reflect separate account performance because a slightly excessive tax reserve was set up. On the other hand, if an inadequate tax reserve was established, the insurer and the present policyholders do not have any recourse against those nonremaining policyholders. Furthermore, there is no reason to reward those terminating policyholders because the insurer's early unrelated start-up losses happened to coincide with their policy ownership, while simultaneously forcing present policyholders to bear the entire burden of taxes and expenses which should be amortized over a reasonable period among all those participating.

Paragraph (2) limits the deduction of brokerage fees to their actual cost. Brokerage fees would naturally have to be reasonable in light of the specific facts and would, as such, have to pass the scrutiny of the Insurance Examiners. Of course, the conflict of interest provisions of Article VI, Section 9 and the standards of conduct in Article VI, Section 8 would be relevant to prevent the "insurer" or its affiliates from being unfairly benefited at the expense of the variable life insurance policyholders. (See Article VI, Section 9c(3).)

It would seem that the Commissioner would possess the power to invoke the full range of administrative sanctions upon an insurer who was somehow unfairly benefiting at the expense of the policyholders by artificially inflating "actual" brokerage fees. (See Article IV, Sections 8 and 9a.)

A "sales load" of a mutual fund would not be considered a brokerage fee within the meaning of Article VI, Section 7(a)(2) but rather was intended to constitute a cost of obtaining "investment management" within the meaning of Article VI, Section 7a(4). As such, any sales load would have to be included along with advisory fees, etc., within the maximum permitted charge. (.75%) against the separate account. Thus, the extent to which a sales load would be permitted at all would be governed by Article VI, Section 7a(4) and not Section 7a(2). (See Comment to Article IV, Section 3b(4).)

Technically, brokerage fees are not deducted from the separate account because as an acquisition cost they are never in the separate account. However, for the sake of simplicity, this issue was dealt with in this Section.

Paragraph (3) is required to allow the payment of benefits (see the diagram in the Comment to Article VI, Section 3) and the periodic transfer of tabular costs, etc. Technically, this is not a deduction at all but is rather a transfer.

This Paragraph is not intended to exclude the release of reserves upon partial withdrawal (policy loan), election of a fixed benefit insurance nonforfeiture option, reduction in underwriting classification or other situations in which the reserve should be released from the separate account. In addition, it is not intended to preclude accumulation of mortality gains in the separate account, which will result from a transfer of an amount less than the sum of the tabular cost and the reserves released on death.

Paragraph (4) permits the maximum separate account deduction for investment "management." It is important to note that the term "management" is much broader than the term "advisory" services which was intentionally not utilized. The expenses for investment management consist of all costs which are necessary to secure and transact the investment obligations of the insurer. It would include advisory services as well as other expenses associated therewith. If, for example, an outside mutual fund were utilized, sales commissions, printing fees, outside directors fees, registration fees, required reports, custodian fees, etc. would all be a cost of investment management and would be regulated by this Paragraph.

This Paragraph does not mean that expenses greater than those allowed by this Section cannot be incurred, but rather only that such excess must be derived from premium income and cannot be deducted from the separate account. However, the conflict of interest provisions of Article VI, Section 9 will, of course, apply. At one time this Paragraph limited deductions to "actual" expenses. The word "actual" was deleted because the Subcommittee felt that the stringent limits and wide scope of this Paragraph would result in costs near the maximum. However, since the intention of this Paragraph was to force most unrelated expenses and profit into premium, the Subcommittee expects examiners to inquire as to the reasonableness of the deduction as compared to expenses. Suitable inquiries may be required in the insurers annual statement in order to isolate the information necessary to make the proper regulatory adjustments if required in the future.

Early drafts of the Model Regulation improperly ignored the need in variable life insurance to provide for the contingency that poor mortality experience would exist at the same time that investment performance was favorable.

In fixed benefit life insurance when mortality is unfavorable, the insurer would have to pay benefits to a greater number of people. In variable life insurance if mortality was unfavorable at a time when investment performance was favorable the insurer would have to pay benefits not only to this greater number of claimants, but the benefit to every one of this greater number would be increased according to policy design. While it is possible to provide for this contingency through an extra conservative assumption in the premium, the possible cost of this contingency will more directly relate to investment performance and is, therefore, more reasonably taken as a charge against the separate account.

If this contingency had to be provided for in the premium, the cost assumptions would have to be extra conservatively estimated since the insurer could not later raise the premium. By reserving against that contingency in the manner described in the text, as this risk increases, the reserve, therefore, also increases in direct proportion.

Paragraph (5) is in response to this situation. It applies to the average net asset value of the separate account as of the date of valuation.

Under the Model Regulation, a company would be permitted to utilize the .5% maximum limitation authorized by the Paragraph to fund as much of its initial face value guarantee as could be paid for within the limits of this Section. The limits of this Section may or may not practically require at least a portion of the initial face value guarantee to be provided for elsewhere, presumably the premium.

The NAIC was fully cognizant of the fact that by limiting charges against the separate account rather severely in this Section the necessary effect would be to raise premiums. However, the intention of this Section was to place greater emphasis on competition in the premium where price benefit comparison was more feasible to the policyholder.

Because there was not total certainty as to the extent of the effect of this Section on the increase in premiums, the decision was made for the time being, not to further adjust the controlling premiums. Reducing the maximum authorized charges against the separate account produces an effect which is equivalent to lowering the controlling premiums. (See Article IV, Section 3g.)

Subsection b applies to both affiliated and unaffiliated funds and was designed to discourage pyramiding of charges. Thus, all expenses by all persons under Paragraphs (4) and (5) must be combined to establish compliance with this Section.

Section 8 – Standards of Conduct

SOURCE: New

COMMENT: This Section provides the minimum standards of duty and care which are owed by the insurer to the policyholders. They can be enforced by the Commissioner through the full range of methods available to him. In addition, the insurer itself can enforce the standards as can an individual policyholder if an implied private right of action exists. (See e.g., Rhine v. N. Y. Life 273 N. Y. 1.)

The Standards of Conduct would not be required to form part of the insurance contract pursuant to Article IV, Section 3h, although an insurer might choose to include them in the policy.

Additional items might include expressions of the nature of the quasi fiduciary duty of management to the policyholders and the obligations of good faith under which the insurer's management is bound to operate.

Section 9 – Conflicts of Interest

SOURCE:

COMMENT: Subsection a is designed to incorporate by reference and apply all state conflicts of interest laws. As such, it should be broadly interpreted.

"A separate account committee or other similar body" was intended to include any form of internal management group responsible for the operation of the separate account. For example, if an insurer did not form a variable life insurance subsidiary but rather formed a new committee of its board of directors (similar, for example, to the Executive Committee) to make the more day-to-day type of variable life insurance management decisions, this would be the type of group to which the Model Regulation refers. The intention of this Section was clearly to not permit the insurer's board of directors to delegate the ultimate management responsibility for separate account activities to any other group, such as the policyholders, or distinct separate account management. This was in recognition of the nature of the separate account's integrated relationship with the insurer as a whole.

Furthermore, this language was meant to preclude policyholder voting for the management of variable life insurance operations. Finally, this Section was inserted to assure no misunderstanding that the conflict of interest provisions applied to any group associated with a separate account regardless of its description.

The Model Regulation contains no other reference to such a "body."

The responsibility of the board of directors to manage the insurer including its variable life insurance operations is much broader than only those acts treated in the conflicts of interests section. It is spelled out in detail in state insurance laws. This responsibility would include a quasi fiduciary duty to act in the interest of the policyholders and in compliance with the Standards of Conduct.

The second sentence of this Subsection is not intended to prohibit payment of a regular salary or compensation including directors and committee fees.

The last sentence of this Subsection is not intended to make directors absolutely liable in the legal sense. Rather, it means that final responsibility for the management control of the insurer resides in the insurer's board. This implies only that directors shall discharge their duties in good faith and with that degree of diligence, care, and skill which ordinary prudent men would exercise under similar circumstances.

The provisions of Subsection b are self-explanatory. Paragraph b(4) is an attempt to define "overreaching." It should be noted again that the term "insurer" includes all separate accounts.

Subsection 9c is intended to make clear that the practices enumerated therein are not prohibited by Subsections a and b. The payment of fees to an affiliated fund (see Article II, Section 1) pursuant to Paragraph (1) is not prohibited. However, consistent with Article VI, Section 7a(4) the fees should be examined closely for possible conflicts of interest.

Clearly, there is no requirement for a Commissioner's approval for the activities described in Article VI, Section 9(c)(2). However, such conduct may be regulated by Article VI, Section 9(b)(4) which prohibits joint transactions which would benefit the insurer or any of its affiliates while simultaneously disadvantaging the insurer or any of its other affiliates. It should again be noted that a separate account is part of an insurer and not an affiliate. Thus, prior approval would be required in circumstances involving Section 9(b)(4). As with all matters relating to separate account operations, primary supervision would be by the state of domicile, although any Commissioner would be watchful for activities which could harm policyholders in his state.

While authority exists in the Model Regulation for the Commissioner to give approval to a proposed series of transactions under Section 9, it is anticipated that such approval would be given only on a limited and conditional basis. Even though such a proposed series of transactions could be approved, the Model Regulation would still require that each proposed transaction in the series would be detailed with such specificity that the Commissioner could make an informed determination as to its fairness pursuant to the aforementioned considerations.

Following the promulgation of the regulation the Chairman of the (C4) Subcommittee was asked if the Model Regulation prohibited "the acquisition by the separate account of a security during the existence of any underwriting or selling syndicate for such security if a member of such syndicate is an officer, director, member of an advisory board, investment adviser, or employee of the separate account or is a person of which any such officer, director, member of an advisory board, investment adviser of employee is an affiliated person?"

Because this question has been raised, the Subcommittee has decided to incorporate his response herein for its interpretive value: "Such conduct is prohibited by Article VI, Section 9 generally as well as Article VI, Section 9a, Section 9b(1), (2), and (3) as well as Article VI, Section 8 specifically. Any such acquisition would also be governed by Article VI, Section 3. Furthermore, it should be noted that no one can be an "officer, director, investment adviser, or employee" of a separate account since a separate account is not a severable entity from the insurer. As for members of "advisory boards," we assume that you are referring to the type of body referred to and previously explained under Article VI, Section 9a. We would note in this regard that Article VI, Section 9a provides that "no officer or director of such company nor any member of any managing committee or body of a separate account shall receive directly or indirectly, any commission or other compensation with respect to the purchase or sale of assets of such separate account."

Subsection 9c(3) contains a typographical error which was not discovered in the version adopted by the (C4) Subcommittee. It should have read as follows and will be amended accordingly:

> (3) an insurer or an affiliate to act as a broker or dealer in connection with the sale of securities to or by such separate account; however, any commission fee or remuneration charged theretofore shall not exceed the minimum broker's commission established for any such transaction by any national securities exchange through which such transaction could be effect or, where such charges are subject to negotiation or where no minimum charge is applicable, then such charge shall be consistent with the charges prevailing, in the ordinary course of business in the community where such transaction is effected; (Accidently omitted material is underlined.)

This Paragraph was intended to make clear that a broker which was affiliated with the insurer could perform brokerage functions for that insurer. However, if this were the case the brokerage fee must be the minimum for which the transaction could be effected. Where no minimum is applicable than charges must be consistant with prevailing charges. Brokerage fees must result from "actual" transactions performed. (See Article VI, Section 7a(2).) An affiliated broker which performed no actual services would not give rise to a fee which could be either deducted from the separate account or retained from any source. (See Article VI, Section 9c(2).)

The same would be true for Paragraph 9c(4).

Pursuant to Section 9d the Commissioner could approve a series of transactions upon a determination that such transaction or series is not unfair or inequitable. Naturally, the basis for making this determination would be whether or not a proposed transaction was an equitable, arms-length transaction among all parties affected thereby.

Section 10 – Investment Advisory Services to a Separate Account

SOURCE: Most of Subsection a(2)(D) is derived from Section 3(e) of the Federal Investment Advisers Act. The remainder of this Section is new.

COMMENT: In most instances the Subcommittee anticipated that investment "advice" would be performed by the insurer internally in the same manner as fixed benefit life insurance. However, the Subcommittee was aware that a substantial number of insurers might wish to utilize investment advisory services either within or outside their corporate family – hence this Section was inserted.

It should be noted that a separate account is not a "person" and cannot contract with an investment adviser. Consistent with this philosophy, this Section has no application to an insurer's internal investment management. Naturally, the remainder of the regulation including the standards of conduct and conflicts of interest provisions are applicable in the internal management situation. (See also Comment to Article VI, Section 7.)

An investment advisory contract must be in writing. (See Article VI, Section 5 as well as Article VI, Section 7a(3).) The adviser must be either a "registered investment adviser" under the Investment Advisers Act of 1940, or the insurer must file a statement in compliance with Subsection a(2) of this Section annually. (See Article III, Section 6d.) This report, in effect, requires the "adviser" to adopt standards of conduct which are sufficient to satisfy Article VI, Section 8.

As noted above, while Paragraph a(2) is derived from the Investment Advisers Act, Subparagraph (iii) thereof includes an additional statement of any insurance law or regulation violations.

Paragraph (2) does not prohibit employment of persons noted in Subparagraph (D). However, the insurer would be placed under an extremely heavy burden to demonstrate no hazard to the public.

Paragraph (3) requires any advisory contract to be in writing and terminable by the insurer without penalty on at most sixty days notice.

Subsection b gives the Commissioner the authority after notice and the opportunity for hearing to compel termination of a contract which imperils the public or the policyholders of the insurer (either variable, fixed, or both).

A change of investment advisers of the assignment of an advisory contract, would in all probability be a "change in investment policy." As a "change," it would have to be submitted to and approved by the Commissioner pursuant to Article VI, Section 6. The continuing supervisory nature of Article III, Sections 1 and 2b would imply notification of the Commissioner of a change in the plan of operation. Thus, the Commissioner would have to be notified.

ARTICLE VII: INFORMATION FURNISHED TO APPLICANTS

SOURCE: Sections 1 and 2 are derived from the addendum to the original NAIC Model Variable Contract Regulation. The remainder of this Article is new.

COMMENT: This Article was designed to provide information to a prospective purchaser concerning the operation and performance of a particular policy.

The question of what is "adequate" disclosure is quite subjective. The primary concern of the Subcommittee is, of course, that the insured realizes that he is buying an insurance policy and that a prospect has enough information to make a reasonably informed judgment as to whether the purchase of any particular policy is consistent with the needs he perceives. Another obviously important concern is that the prospective purchaser be able to compare premiums and benefits of various otherwise similar policies.

In view of this, there is virtually no limit to the possible information which could be provided. This is revealed in the approximately 110,000 pages of data produced in the Hart Committee's recent inquiry into only a relatively small segment of "cost comparison." Submerging the prospective purchaser with information can as a practical matter thwart the purpose of disclosure as well as failing to provide sufficient information. At the time the Model Regulation was drafted, it was felt that at the time of sale the prospect would be overwhelmed with "disclosure" information required by both the states and the SEC. Therefore, an attempt was made to limit information to that which would perhaps be most understandable and relevant. For example, early drafts of the Model Regulation required disclosure of the percentage of premiums which made its way into the separate account. It was recgonized that this figure was totally unrelated to benefits payable or the relative merits of a particular policy. Therefore, this proposal was deleted.

The Model Regulation was prepared in an atmosphere which recognized, pending resolution of the jurisdictional question, that for the time being, the prospectus requirements of the Securities Act would be applicable. (See the Introductory Paragraph to Article VII.) If such were not the case, the Model Regulation would have gone further in the area of disclosure. If the jurisdiction of the SEC under the 1933 Act is found not to exist, immediate further activity as to this position of the Model Regulation is contemplated.

The question of proper "cost comparison" has not yet been resolved to the satisfaction of the Subcommittee. This issue is quite complex and transcends the illusory border between variable and fixed benefit life insurance. Accordingly, this problem has been referred to NAIC's Life Insurance Cost Comparison Task Force for study and recommendation as part of their already commenced project.

The Model Regulation provides in Article III, Section 6b that any "Information Furnished to Applicants" pursuant to Article VII be furnished to the Commissioner prior to its use in the state in question. Additionally, Article III requires a written acknowledgement of receipt by the applicant coincident with or prior to the execution of the application for a variable life insurance policy. The insurer would be required to maintain such receipt at least until its examination in order to be able to prove compliance with this Section, and probably for a longer period in order to protect itself against claims that the mandates of this Article were ignored.

The Commissioner will further have the market conduct portion of the examination system as well as the normal complaint mechanism to see that insurers are fulfilling their obligations pursuant to this Article.

Failure to comply with this Article would subject the insurer to the entire range of remedies available to the Commissioner. Furthermore, recision would presumably be available to the policyholder either as a personal equitable remedy or administratively through the Commissioner.

In recognition of the present jurisdictional framework, the Subcommittee determined to allow the use of a prospectus filed pursuant to the Securities Act of 1933 to the extent that it contains information required by Article VII.

Section 1 was intended to remain flexible and can be utilized to require proper disclosure of significant policy features, e.g., Article IV, Section 3a(5) and Article IV, Section 3a. However, the Commissioner may wish to amend this Article to specifically require inclusion of these Sections.

Section 2 refers to investment policy. Both the description of investment policy and the restrictions enumerated must, of course, comply with the regulation. (See e.g., Article IV, Sections 3 and 4.) It will be a significant factor in determining what constitutes a change or material change in investment policy since this description is what a policyholder was entitled to rely upon.

This statement should include, for example, such items as limitations on investments in particular industries as well as the expected diversification of investments allocated to the separate account.

With respect to Section 3 the net investment return referred to will not take into account policy loans if held as an asset of the separate account. (See Article IV, Section 4b(12) and Article VI, Sections 3a(1) and 7a.) It is recognized that the "net investment return of the separate account" is a figure that is extremely unlikely to apply to any single policy, because of differences in timing of transfers of net premiums and tabular costs of mortality, etc. This figure is intended to provide a useful indication of the general investment performance of the separate account, after deductions, for comparative purposes. It is anticipated that this figure will be shown in the NAIC annual statement and will be computed in accordance with instructions for completing the annual statement. This Section, as well as Section 5, does not preclude the use of figures that are not more than 16 months old. Applicants during the first four months of a calendar year cannot be expected to receive information for the calendar year just ended less than four months ago.

The requirements of Section 4 were not intended as a cost disclosure device. (See, however, Article VI, Section 7.) Rather the disclosure of commissions was required to show the interest of an agent in selling this particular kind of policy. Meaningful cost comparisons on the basis of commissions are impossible. This would be true even if business methods were uniformly comparable.

In view of this, the regulation would not prohibit an insurer from cautioning against cost comparison based solely on agents commissions so long as these cautionary remarks were not themselves deceptive or misleading.

Some of the problems in this area stem from determining what constitutes a commission. A direct mail insurer may have sales expenses but no "commissions," thus, his "disclosures" might appear artificially low as compared to an insurer doing business in the more traditional agency method. Also, there exists, for example, the problem of classifying the amount of a vacation trip awarded as a bonus for sales of all life insurance (variable and fixed) by an agent.

There is presently no nationwide uniform standard which will satisfy this Section. However, pursuant to Article III, Section 6b, the form to be utilized in compliance with this Section must be filed with the Commissioner prior to use. Pursuant to Article III, Section 6e, if the Commissioner finds it misleading, he is required to disapprove such form and require an amended report. Thus, the Commissioner in each state will have the ability to assure uniformity within his state for all applicants for variable life insurance.

Sales related costs not forming compensation to salesmen and other persons are not required to be disclosed by Model Regulation. It was the feeling by the Subcommittee that sales commissions are not very helpful in determining cost comparison but rather are relevant to demonstrate the salesman's interest in selling a particular kind of policy to a prospect.

Other persons as used in this Section would include anyone who is "benefited" by the sale regardless of their description (i.e., salesmen without commissions, field agents, branch managers, etc.).

Section 5 must be read in conjunction with Article IV, Section 7a. If actual tax figures aren't available, reasonable estimates or reserves for taxes must be supplied. "Brokerage fees and similar costs" refers to the transactions described in Article VI, Section 7a(2). (See Comment Article VII, Section 3.)

Section 6 should be read with reference to the limitations of Article VI, Section 5.

Section 7 refers to the federal income tax liabilities to persons insured, policy owners, and beneficiaires in general and not to particular specific circumstances of each insured, etc. Opinions of counsel, if necessary in the absence of specific rulings, should be labeled accordingly.

Section 8 regulates benefit illustrations. It prohibits the projections of past investment performance into the future, or any predictions of future performance. However, past performance can be shown with appropriate caveats. (See Article VII, Section 3.) Some states, in fact, require such a demonstration. The Subcommittee specifically requires all benefit illustrations to be prepared by the insurer in order that they take full responsibility and to preclude unfair, or inexact, off the cuff illustrations prepared at the point of sale.

The question of which hypothetical rates of return would be permitted has been referred to the NAIC (B6) Subcommittee for their recommendation in conjunction with their work in drafting a model regulation on life insurance advertising (1 NAIC Proceedings 1974 p. 462). This Section does require a clear identification of hypothetical rates and an indication that they are unrelated to actual performance.

When the work of the (B6) Subcommittee is completed, it is anticipated that there will be uniformity in this area. While no single Commissioner in the absence of such uniformity would have the power to require such uniformity nationwide, he certainly could require all the information to all applicants in his state to be identical, thereby as a practical matter allowing comparison.

Section 9 was inserted because of the Subcommittee's concern that variable life insurance would be falsely portrayed to the public as an investment or a product which was comparable to a mutual fund. (See Article III, Section 4.)

While this Article does not specify a location for the statements required herein, Section 9 does require a "prominent" statement. Thus, its location in any disclosure document (either in a prospectus or in a separate document pursuant to this Article) is important. Regulators should be wary of attempts to "bury" this important disclaimer.

ARTICLE VIII: APPLICATIONS

SOURCE: New

COMMENT: Sections 1 and 2 should be read with reference to the Comments to Article IV, Sections 3a(1) and (2). Section 3 is referred to in the Comment to Article III, Section III and Appendix A.

ARTICLE IX: REPORTS TO POLICYHOLDERS

SOURCE: Subsections 2a and c are derived from the Model Variable Contracts Regulation.

COMMENT: The Model Regulation is designed to provide the policyholder with as much relevant information as possible at a time when it is useful and in a manner so as to avoid vastly increasing costs. Normally, an insurer will send out its premium notice in advance of the policy anniversary date. This is essential to minimize the possibility that a policyholder will inadvertently lapse his policy. The regulation seeks to provide the policyholder with information at a time which could enable him to make an informed decision as to whether he should continue the policy. At the same time, however, insurers raise the legitimate desire to send disclosure reports along with premium notices so as to avoid costly extra mailings. Thus, the Model Regulation provides for an insurer to make an annual statement of the policy's death benefits, cash values, and indebtedness as of the policyholder's anniversary date. However, an insurer may set any specified date in each policy year (e.g., the date of its normal premium notice) on which it will calculate the required data and send its statement -- so long as the information contained therein has been determined within the last forty-five days. This would enable an insurer, if it so desires, to send all required reports in one mailing. The reports of benefits must prominently identify those values which may be recomputed prior to the next annual report.

It should be noted that a significant choice had to be made in order to accumulate this single mailing of all policyholder reports along with the premium notice. Some of the information given to some policyholders will not be entirely current. For example, the filing of the annual statement with the Insurance Commissioner will correspond with the premium notices on only one-twelfth on an insurer's annual mode policyholders. The NAIC had to choose between requiring the expense of more than one calculation and mailing (ultimately paid for by the policyholder), the policyholder receiving outdated information as to his benefits (and, thus, being unable to effectively analyze it in making a determination as to whether he should continue his policy), or the present scheme in which some of the impersonal data to some policyholders would be partially outdated. The decision made recognized that the most significant information to the policyholder is the level of his personal benefits which are, as a practical matter, a summary and crystallization of the other financial data presented in an understandable manner. The extra cost (to be borne ultimately by the policyholders) of multiple mailings financial data did not justify the requirement of more than one mailing.

Unlike Article VII, this Article would not be satisfied by delivery of a document meeting the requirements of the Securities Act of 1933 or the Securities Exchange Act of 1934, but rather would require separate notice.

Pursuant to Article III, Section 6c, the insurer must file with the Commissioner the form of any Report to Policyholders provided for in this Article prior to its use in a particular state. Article III, Section 6e provides that the Commissioner must disapprove such form if he finds it to be false, misleading, deceptive, or inaccurate in any material respect. If such a finding is made after any distribution has been made to the public, the Commissioner must require the distribution of an amended report. In the meantime, pending redistribution, the policyholder has had continuing coverage. If, however, a decision to continue the policy was in reliance on misleading information contained in the report, it would seem that the Commissioner would have the authority to require a premium refund. This would be in addition to any private legal remedy which might exist.

Section 1 provides for reports to individual policyholders concerning the status of their particular policy benefits. The information is on an annually current status basis only and this Section does not require a total report for the life of the policy. The second sentence allows the insurer to set the date for a report under this Section which would enable a single mailing with the premium notice. In other words, the specified date might be ten months following the inception of the policy. The mailing could then be made at the beginning of the eleventh month. This procedure would allow a combined mailing with Section 2. Subsequent years' reports would have to follow the same pattern.

This Section requires the same statement as required by Article IV, Section 3a(1) – a clear identification in contrasting color or distinctive type (see e.g., Article IV, Section 3a(1)) of benefits which may fluctuate before the next policyholder report. The only time this will not be the case is with annual death benefit valuation. (See Article IV, Section 2g.) The last sentence of this Section covers that situation.

As noted above, some of the information required by Section 2 will be somewhat out of date to some people if a single mailing is utilized.

Subsection a requires a summary of the financial statements of the "separate account" based on the annual statement last filed with the Commissioner. Action in this area is anticipated upon finalization of the variable life insurance blank. In reality, the separate account not being an entity, has no financial statement. The assets allocated to the separate account form an integral part of the insurer's annual statement and a summary of that, including separate account information, is what is required by this Section.

The annual statement to be filed with the Commissioner will be prepared in accordance with the statutorily mandated insurance accounting principles with respect to variable life insurance.

As a general proposition, all Commissioners require the same basis of accounting for annual statements. However, individual states do require supplemental information according to the requirements of their state. It is not unreasonable to expect that the same high degree of uniformity will exist for variable life insurance annual statements as presently exists for fixed benefit life insurance.

The basis of accounting for the separate account will differ to some extent from the basis for the general account. However, the two bases of accounting will be consistent and cross-referenced inasmuch as the separate account statement is a necessary and integral part of the annual statement of a life insurance company.

The Comment to Article VII, Section 3 is relevant to Article IX, Section 2b. The term "investment rate" is synonymous with "net investment return."

Subsection 2(c) is derived from the original Model Contracts Regulation. It requires a list of investments. The Model Regulation does not require cost and current market value for each investment included in the statement pursuant to this Subsection.

Subsection d is related to Article VI, Section 7a. However, a percentage rate as well as a dollar amount is required in each category as well as the total.

The portfolio turnover rate of Subsection e is designed to indicate whether an insurer is generating excessive and unwarranted brokerage fees. (See also Article VI, Section 9c(3) and Article IX, Section 2g.)

Subsection f refers to Article IV, Section 3o; Article VI, Section 6; and Article VII, Section 2.

In Subsection g, the standard for determining a "material direct or indirect interest" is that of "affiliation" or "control" pursuant to Article II, Sections 1 and 6.

Subsections h and i require no explanation.

ARTICLE X: QUALIFICATION TO SELL VARIABLE LIFE INSURANCE

SOURCE: Sections 9a, 2, and 3 are derived from Article IX of the Model Variable Contracts Regulation. The remainder of this Article is new.

COMMENT: The present division of regulatory authority over variable annuities and variable life insurance between the state insurance departments and the Securities and Exchange Commission has resulted in the potential dual licensing of salesmen. The states developed, for variable annuities, a special "variable contract agent" license which required licensing as a life insurance agent plus successful completion of a variable contracts exam given by the insurance department, plus ownership of a federal securities sales license. An alternative manner of obtaining the latter was successful completion of a federal securities examination administered by the insurance departments, developed by the NAIC, and approved by the SEC. A few years ago, the NAIC withdrew from participation in this examination procedure. Thus, at present, only a federal securities examination administered by a securities regulatory body will satisfy step three noted above.

Variable life insurance for the time being, may also require a dual licensing approach -- by the insurance departments and by the SEC. However, the Subcommittee believed that variable life insurance marketing will develop in a manner different from variable annuity marketing, and, thus, will require a different state insurance licensing procedure.

The variable contract license was developed on the theory that not all life agents would be interested in selling variable annuities. Given that assumption, it was clearly unnecessary to test for variable knowledge anyone other than those with a real interest in selling variable annuities. In practice, this assumption turned out to be accurate. Relatively few companies have entered the variable annuity field and individual variable annuities have become at most a minor life insurance product line.

However, the Subcommittee was of the opinion that the same assumption will not hold true for variable life insurance. If proper regulation is forthcoming, we expect variable life insurance to become a major individual life insurance product line. As such, most life companies will be forced, for competitive reasons, to enter the field, at least half-heartedly. Even when that is not the case, the agents of such a company will find themselves competing with variable life insurance.

Whether they are selling variable life or competing against it, life insurance agents must know how variable contracts work and how they are regulated. In order to assure that they have the required knowledge, the Subcommittee believed all life agents and brokers should be examined on variable contracts just as they are examined on aspects of traditional life insurance and its regulation. The Model Regulation has been changed to reflect this position, as has the NAIC Uniform Agents and Broker's Licensing Act (1 NAIC Proceedings 1974 p. 276).

It is hoped that the movement toward standardized testing will also incorporate this attitude. The (C4) and (B2) Subcommittees may find it desirable to coordinate their efforts in this regard.

Subsection 1a requires a person to be licensed as an "agent" in order to be eligible to sell variable life insurance to the public. (See Article II, Section 2.) Such person must provide satisfactory evidence that he holds any securities license which may be required for the sale of variable life insurance. This does not constitute a recognition on the part of the Subcommittee, that there is any jurisdiction over variable life insurance under federal or state securities law.

Subsection 1b reflects the single life insurance agent licensing approach.

Section 2 requires that an agent report, to the Insurance Commissioner, any disciplinary actions against him by other insurance departments or by Securities Exchanges, associations or regulators. Upon receipt of such notification, the Commissioner may find the agent ineligible for further licensing as a life insurance agent or unqualified as a variable contract agent, or he may investigate for similar violations by the agent in that state for which further disciplinary action or remedial action is needed. (See Article X, Section 3.)

The difficulty with this scheme is the need for an independent source of information for the Commissioners. Obviously, it is helpful but unrealistic to expect an agent to report a disciplinary action against himself. With regard to disciplinary actions by insurance departments, an independent source is available through the monthly NAIC Agents List. The Subcommittee recommends that each state religiously report disciplinary actions through this system and utilize the resulting national monthly list.

No such vehicle is presently available to insurance departments with regard to securities law disciplinary actions. The Subcommittee believes, however, that such a source may be made available with the expansion of the NAIIO. In addition, cooperation and coordination with the SEC and self-regulatory associations in this area may prove valuable if securities jurisdiction is ultimately upheld.

Section 3 applies the rules and regulations applicable to fixed benefit licensing, revocations, suspensions, etc. to variable life insurance.

ARTICLE XI: SEPARABILITY ARTICLE

SOURCE: New

COMMENT: None

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THE SUITABILITY PROVISION OF THE NAIC MODEL VARIABLE LIFE INSURANCE REGULATION

1. Introduction.

Apparently, there has been some lack of certainty within segments of the life insurance industry as to what obligations are imposed upon a company and its agents by the suitability provisions of the NAIC Model Variable Life Insurance Regulation (Article III, Sec. 3). In response to this problem, this memorandum is intended to explore this section and to suggest for the consideration of the (C4) Subcommittee a possible interpretation as to what "suitability" is intended to imply.

2. The Regulatory Language.

Art. III Sec. 3. Standards of Suitability.

Every insurer seeking approval to enter into the variable life insurance business in this state shall adopt by formal action of its Board of Directors and file with the Commissioner a written statement specifying the Standards of Suitability to be used by the insurer and applicable to its officers, directors, employees, affiliates, and agents with respect to the suitability of variable life insurance for the applicant. Such Standards of Suitability shall be binding on the insurer, and those to whom it refers, and shall specify:

a. that no recommendation shall be made to an applicant to purchase a variable life insurance policy and that no variable life insurance policy shall be issued in the absence of reasonable grounds to believe that the purchase of such policy is not unsuitable for such applicant on the basis of information furnished after reasonable inquiry of such applicant concerning the applicant's insurance and investment objectives, financial situation and needs, and any other information known to the insurer or to the agent making the recommendation.

b. Lapse rates for variable life insurance within the first two policy years which are significantly higher than both those encountered by the insurer or an affiliate thereof for corresponding fixed benefit life insurance policies and lapse rates of other insurers issuing variable life insurance policies shall be considered in determining whether the guidelines adopted by the insurer are reasonable and also whether the insurer and its agents are engaging, as a general business practice, in the sale of variable life insurance to persons for whom it is unsuitable. For purposes of this subsection, conversions from variable life insurance to fixed benefit life insurance policies pursuant to this regulation shall not be considered lapses.

3. Background.

The inclusion of a suitability provision was in partial response to a concern of the NAIC that variable life insurance might be missold and/or oversold, with the resultant possibility that early lapses might be numerous.

This provision was a result of the growing complexity of life insurance products and the changing obligation of the insurer and its agents. The professional agent should be and is becoming more of an advisor, utilizing his technical insurance knowledge, experience, and training to lead a prospective insured through a labyrinth of insurance products, each designed for different needs. As the agent's professional status grows, so does his responsibility to his client.

> The duties and liabilities of the insurance agent are basically the same as in the case of other professionals. The agent must act in good faith . . . and exercise such reasonable skill and ordinary diligence as may be fairly expected from a person in his situation.[1]

As Professor Keeton states: "Often the liability of an intermediary to an applicant is based upon his superior knowledge, or upon his holding himself out as an expert advisor on insurance matters or both."[2]

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1. Hoeveler, "Architects, Engineers of Insurance Agents Professional Liability," ABA Section of Insurance, Negligence and Compensation Law, Proceedings 1966 p. 222.

2. Keeton, Insurance Law, A Basic Text, Sec. 2.5(a), p. 53.

Thus, as have a number of courts,[3] the NAIC has taken the position in the model regulation that, considering the relative expertise of the insured, the insurer, and the agent, the recommendation of the sale of any product, including variable life insurance, implies a determination by the insurer through its agent that such a purchase is reasonable for the consumer.

While the actual language of Art. III Sec. 3a is based on SEC Rule 15b 10-3, the concept of suitability is not foreign to insurance.[4] In fact, those who saw the earlier drafts of the model regulation will recall that the suitability provisions were more extensive than at present. They were modified at the suggestion of several SEC staff members and insurance industry representatives who expressed concern ensuing from a potential conflict between the NAIC and SEC requirements. Illustrative of the insurance background of "suitability" is the case of Anderson v. Knox, 297 F. 2d 702 (9th Cir., 1961), cert. den. 370 U.S. 915 (1961), which serves as a valuable introduction to this subject.

Anderson, an insurance agent, sold a "bank-financed" insurance program with a ten-payment $100,000 policy calling for a $7,265 annual premium to one Knox, a 36-year-old field superintendent with an annual income of $8,100. The program was extremely complex and called for the conversion of Knox's present $35,000 of coverage. The premiums were to be financed by bank loans and purportedly offered tax advantages to persons in higher income tax brackets. Anderson recommended this plan, despite never having inquired into Knox's tax bracket. On this abbreviated description of the facts, the District Court found (162 F. Supp. 340) that Anderson failed to disclose to Knox certain material information and facts which he knew with respect to the proposed insurance plan, that Anderson was under a duty to make disclosure because of a relationship of trust and confidence, and because of Anderson's superior knowledge; the court concluded that liability on the part of Anderson accrued not only from the alleged false and fraudulent representations, but also from these failures to disclose.

The 9th Circuit held that there was "such a representation of suitability and that such representation was not true in that the insurance program sold to Knox was in fact not a suitable one in view of all the facts then existing with respect to him – his income, his financial condition, his prospects, his family, and their prospective needs.[5]

The Court further dismissed the need for a fiduciary relationship (which was assumed not to apply) in order for Knox to be entitled to rely on Anderson's implied representation of suitability. The message of the Knox case is that those who would sell complex insurance products clearly have the obligation to make a good faith effort to determine the suitability of those products for the applicant.

Furthermore, much like the model variable life insurance regulation, the NAIC Model Regulation on Deceptive Practices in Life Insurance, adopted June 6, 1973, makes it an unfair practice and deceptive act to recommend "to a prospective purchaser the purchase or replacement of any life insurance policy or annuity contract without reasonable grounds to believe that the recommendation is not unsuitable for the applicant on the basis of information furnished by such person after reasonable inquiry as may be necessary under the circumstances concerning the prospective buyer's insurance and annuity needs and means. (Sec. 5(f) [*sic,* (g)?], 2 NAIC Proceedings 1973, p. 542.) In this context, the model variable life regulation imposes no new requirements but rather is only another means to formalize this desirable result.

4. Suitability in General.

In order to be "suitable," any product must reasonably purport to meet the need for which it is purchased as perceived by the purchaser. However, as a product or service becomes more complex, and the purchaser is encouraged and/or compelled as a result of such complexity to rely on the representations of a professional and experienced vendor as to how well the product meets the purchaser's needs, it becomes clear that the seller's conception of these needs and the ability of his product to meet them becomes an equally significant factor in ascertaining "suitability". It cannot seriously be argued that variable life insurance does not inherently fall into this latter category.

Another aspect of suitability must relate to lapsation. In most instances, an insured who lapses a variable life insurance policy in the first year does so at considerable cost to himself, other policyholders, and the insurer. Thus, high lapse rates

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3. See e.g., Anderson v. Knox 297 F. 2d 702 (9th Cir. 1961); Hardt v. Brink 192 F. Supp. 879 (D. Wash, 1961); Steadman v. McConnell 308 P. 2d 361 (1957); Gediman v. Anheuser Busch, Inc., 299 F. 2d 537 (2d Cir., 1962); Harnett, Responsibilities of Insurance Agents and Brokers (1974), Sec. 3.12 pp. 3-24 - 3-32; Hoeveler *supra* note 1, Liability of Insurance Agents and Brokers, Defense Research Institute Vol. 1970, No. 11; Hume, "Errors and Omissions Liability as Affecting Insurance Agent and Brokers," 1973 Insurance Counsel Journal No. 3 p. 379.

4. See 2 Proceedings of the NAIC 1973 p. 542.

5. 297 F. 2d 702 at 705.

have long been the concern of insurance regulators and insurance companies. Somewhat more recently, agents have recognized the effect of poor persistency on their incomes[6] as well as their public image.

Therefore, in order that variable life insurance be "not unsuitable" under the model regulation involves another crucial element – one which is at least as important as the first two and perhaps more so. That is, what is probability that the proposed insured will lapse his policy within its early years?

Both the background underlying the concept of suitability and the language of the regulation itself indicate that one of the primary motivations underlying the insertion of Art. III Sec. 3 was the intention that "suitability" include a determination of probable persistency.[7]

Thus, it is comparatively simple to isolate the foregoing three general elements: (1) needs perceived by the prospect; (2) needs as perceived by the agent; and (3) probable persistency, which would be present when variable life insurance is ideally "suitable" for a particular prospect. The difficult task becomes determining in each particular case what each element consists of, how well each element is met, and at what point variable life insurance becomes "unsuitable" when one or more of these elements is left partially or totally unsatisfied. Therefore, some general explanation becomes necessary.

5. The Three Areas of Suitability.

(1) Needs Perceived by the Insured.

The NAIC has unequivocably adopted the position that variable life insurance is an insurance product and must be sold as such. It must not be sold as an investment. This feeling underlies the entire model regulation.[8]

The NAIC recognized the growing tendency to sell fixed benefit cash value life insurance as, for example, "a piece of the action." They fully recognized the somewhat increased potential (because of the more speculative investment media underlying the separate account), that variable life insurance could be subject to even greater misunderstanding if it were represented as an investment to the public. In fact, the SEC requirement (pending resolution of jurisdictional issues) that variable life insurance be sold with a prospectus contributes to this fear. All of the witnesses testified before the SEC that variable life insurance is a poor "investment," since it was not designed as such.[9] Insurance regulators, therefore, are committed to prohibit its sale in that manner.

Thus, one of the primary facets of the "suitability" requirement is an inquiry as to whether a prospect is buying the policy primarily for "insurance" or "investment" purposes. Clearly, it should not be for the latter reason. Another inquiry would involve the insured's proposed use of cash values and his need for fixed benefit guarantees.

These inquiries, however, do not end the obligation of the insurer to sell to the needs perceived by the insured. Most of the remainder of the inquiry under the heading of needs as perceived by the insured should duplicate the information needed under element No. 2 (needs perceived by the agent). Overlap between these two elements is significant. However, there is a crucial distinction. Element No. 1 involves a determination of needs by the insured and how well a proposed product seems to meet these needs. These determinations may be realistic or outlandish. Element No. 2 involves a good faith analysis after diligent inquiry of needs and possible vehicles designed to satisfy those needs as determined by a person conversant with insurance planning. The two may or may not coincide; however, an ideally suitable product would certainly contain both elements.

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6. See e.g., Profitable Selling, LIAMA, 1973 pp. 8 - 12.

7. See Art. III Sec. 3b concerning lapse rate comparisons, as well as earlier drafts of the model regulation. See also NAIC Statement to the SEC, File no. 4-149, March 11, 1974, p. 61.

8. See e.g., NAIC Model Variable Life Insurance Regulation, Arts. VII and IX (Reports to Applicants and Policyholders, Art. III Sec. 3 (suitability); Art. III Sec. 4 (advertising), etc.

9. See e.g., NAIC Statement to the SEC, File No. 4-149, March 11, 1974, n.45, p. 62.

(2) Needs as Perceived by an Agent.

This element implies reasonable inquiry into the relevant background information concerning the prospect's financial and family situation, among other things. Should the prospect, consistent with this information, be purchasing variable life insurance, or would another product clearly better suit his realistic needs and objectives? Is he buying it with the sole intention of lapsing after a period of time? If so, when? These are just some of the inquiries which seem to be implied by this element in addition to the normal insurance planning for the insured's needs which should be done even in the absence of formalized "suitability" requirements.[10]

(3) Persistency.

As a general proposition, no one should purchase variable life insurance with the intention of lapsing in the first several years of the policy. It is safe to say that in the foregoing instance, there are much more economical ways of meeting the insured's objectives. Therefore, regardless of how well variable life insurance complies with element Nos. 1 and 2, it becomes quite costly to the consumer and the insurer if a policyholder lapses his policy in the early years.

At first glance, imposition of the requirement that underwriting a risk must consider the probable likelihood of early lapse might be controversial to some observers. However, it is really nothing more than a formalization of what has been undertaken by many responsible companies over the years as a sound business practice in an effort to reduce anti-selection and expenses as well as maximizing income – thereby reducing the cost of insurance.

Furthermore, the number of policyholders harmed by early lapses would be reduced. Lower lapse rates would reduce the cost of insurance to persisting policyholders. The drain on a company's surplus would be lessened. Some assert that agents' income would be substantially increased.[11] Finally, the public image of the life insurance industry, as well as the professionalism of agents, would be greatly enhanced.

Opposition to the concept of including persistency within the meaning of "suitability" centers on the alleged difficulty of predicting the likelihood of early lapses. This memorandum will briefly explore some possible approaches to this problem. However, for the time being, it will suffice to say that while it is true that there are no absolute predictors of which particular individual will lapse in the early years, the research into persistency clearly indicates that factors which indicate high early lapse rates can be isolated and successfully used to predict lapse results. These factors include age, income, occupational group, previous lapse history, previous life insurance, frequency of premium payment periods.[12]

Not surprisingly, the research reveals that persistency improves with age. It further indicates that generally more stable individuals with incomes reasonably related to policy size who are sold by a knowledgeable agent for a recognizable need, who have other life insurance, and who are able to pay their premiums less frequently are more likely to persist with their policies than those who do not meet these characteristics.

This should not imply that persons other than those described above cannot have high probable persistency, but only that each of those factors, among others, is significant in predicting lapses.

> A $20,000 policy on the life of a $15,000-a-year executive may have the poorest persistency if the buyer does not value life insurance, if no real need has been recognized or taught, and if the buyer does not live within his or her income.

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10. E.g., Is the need for insurance temporary, thereby suggesting term insurance, etc.?

11. See e.g., Profitable Selling, LIAMA, pp. 8 - 11.

12. Articles on this subject are attached.

> On the other hand, a $5,000 policy on the life of a gas station attendant may be excellent business if the person values insurance for personal reasons, and is habitually thrifty. If such a person can pay on an annual basis, as shown later, the policy is likely to be especially persistent . . . Life insurance is a public service, and it has a social obligation to make its benefits available to all income classes. Fortunately, research has shown that there are several factors associated with persistency that are independent of the prospect's income and occupation. This means that quality can be improved without neglecting the needs of people with low incomes . . . Actually small policies well sold to thrifty people with low incomes are good business.
>
> It is not suggested that the agent avoid a sale because it does not have all of the factors of good quality business. The problem is to set one's sights on good business and to get more of it – more good business and less poor business.[13]

It would be indeed ironic for an industry which sets its premium rates on the basis of the law of large numbers and the isolation of the risks associated with various group characteristics to object to underwriting for persistency on the same basis. The determination to be reached is basically whether it is likely that the prospect will not lapse until such time that the insurer's acquisition costs are amortized over a reasonable period and that the effect of the lapse on both remaining policyholders and the insurer will be minimal.

Unfortunately, the groups which are most likely to lapse are those in lower socio-economic groups. Thus, to some, underwriting for persistency may mistakenly imply a lack of availability of variable life insurance to a segment of the insurance-consuming public which might be predicted not to persist. This clearly is not the intention of the suitability provision. This section cannot be relied on to justify unfairly discriminatory underwriting practices. What it does mean, however, is that in an effort to obtain persistent business among those classifications with high predicted lapse rates the insurer and its agents must be somewhat more selective in its sales. After all, who is benefited by the sale of a product which is likely to be lapsed and, therefore, is destined not to be able to meet the needs for which it was purchased?

Clearly, the (C4) Subcommittee intended these three general elements – (1) needs as perceived by the insured; (2) needs as perceived by the agent; and (3) persistency – to be within the scope of suitability. However, the definition of suitability can be summed up in the final instruction of an industry pamphlet promoting persistent sales: "Sell the right policy to the right prospect in the right way." (emphasis in the original)[14]

6. Rules of Interpretation.

As previously stated, it is relatively easy to isolate the abstract characteristics of ideal suitability. The more difficult problem is application to a particular set of facts. While it is impossible in advance of regulatory experience to promulgate possible standards for determination of suitability of a particular individual, some consensus of general guidelines can be reached.

a. When all three elements previously described are met clearly, the product would be suitable.

b. Conversely, when none of the three elements are present, the product would be clearly unsuitable.

c. When both elements 1 (needs assessed by insured) and 3 (persistency) or 2 (needs assessed by agent) and 3 (persistency) are present, the product should probably be still "suitable" in most instances. There may be some who would argue that in the absence of No. 1, a product could not be suitable. While academically speaking this may be true, it should not be of great concern, since if the insured could not be convinced that the product were satisfactory, it is unlikely that he would purchase it.

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13. Profitable Selling, LIAMA, p. 25 - 26.

14. Profitable Selling, *supra* note 6 p. 46.

d. Because of the overriding importance of persistency on the ability of variable life insurance to meet its objectives, a product is probably unsuitable in the absence of extraordinary circumstances when it does not meet element No. 3 (persistency).

e. All other situations should be judged on their individual facts.

7. Possible Methods.

The two major reasons underlying the inclusion of a suitability requirement were a concern with early lapses and the possibility that variable life insurance would be sold to meet needs other than those for which it was designed.

The Subcommittee clearly felt that both of these potential problems were likely to be the result of oversales and missales. The model regulation sought to prevent these problems through a number of devices. These include strict regulation of advertising; a free-look provision; disclosure to applicant; a conversion privilege; and a disclaimer of similarity to mutual funds, all in addition to the suitability provision.

The question at hand is how the suitability provision is to be implemented. The model regulation requires that the application contain questions designed to elicit information sufficient to enable the insurer to make a determination as to suitability. Some of these have been previously suggested. However, it is beyond the scope of this memo to exhaust the possibilities in this area. It should be noted that "suitability" questions in variable annuities have not been notably successful because a number of applications are forwarded with the box checked, indicating that the applicant did not choose to reveal the information. How many times this is done by the agent and how many times by the applicant is unascertainable. However, the problem is likely to be encountered in the absence of strong company and regulator discouragement of this practice. The lapse rate comparison of Art. III Sec. 3b may provide some relief. Furthermore, the model regulation does require reasonable inquiry by the agent. This provision should be rigorously enforced, perhaps by spot-checking or follow-ups of a sample of "prospects" who elected not to reveal such information (i.e., during the course of an insurer's examination).

In the area of lapses, several companies have been successful through the use of so-called "persistency raters". Two of these are attached as portions of papers on persistency, wherein their utilization is discussed. One of these raters, along with other means, enabled a company within a relatively short period of time to go from lapse rates in the worst 5% of the industry to the best 9%. Whatever method is used, however, it is very clear that factors associated with high lapse rates can in fact be isolated among groups and used for prediction purposes. A possible controversial long-term approach suggested by some (well beyond the scope of this memorandum) is the scaling of agents' commissions to the persistency characteristics of the applicant, with a bonus for high persistency. This was one measure used to achieve the dramatic results mentioned above.

Unquestionably, the more knowledgeable career agent's clients have lower lapse rates. Basing his presentation on this fact, a representative of the NALU speaking at the (C4) meeting in Oklahoma City suggested that the Subcommittee examine the possibility of increased seasoning and more extensive required training for variable life insurance agents.

Because of the similarity of variable and fixed life insurance, in drafting the model regulation, the Subcommittee expressly decided that there should be a single license for life insurance agents. In light of the lapse figures, however, the proposal for higher agent standards in general as suggested above may warrant further study by the NAIC consistent with the single license approach.

In short, the isolation of those persons for whom variable life insurance is generally suitable calls, above all, for insurance regulators to require and instill in insurers the commitment to underwrite for suitability (including persistency) as described herein for the benefit of themselves, their agents, the policyholders, and the public.

8. Suggestions.

Based on the foregoing, it is suggested that the Subcommittee:

(1) Consider the following language as an informal consensus as to the meaning of suitability in the model variable life insurance regulation:

"Suitability means the likelihood that the purchase of variable life insurance is reasonably consistent with:

(1) the expressed insurance objectives and needs as perceived by the prospective insured; and

(2) the reasonable objectives and needs of the prospective insured as determined objectively by a professional agent after a diligent reasonable inquiry into relevant financial, family, and other background information concerning the prospective insured; and

(3) the potential that the prospective insured will persist with the policy for such a period of time that the insurer's acquisition costs are amortized over a reasonable period of time.

General Rules of Interpretation.

1. When variable life insurance meets characteristics 1 and 3 or 2 and 3, it is probably still "suitable" in most instances.

2. Variable life insurance is clearly unsuitable when it meets none of the three characteristics for a given prospect.

3. Variable life insurance is probably unsuitable in the absence of extraordinary factors when it does not meet characteristic 3.

4. Other situations must be judged on their individual facts."

(2) Clearly indicate its intention, consistent with the Executive Committee resolution of May 7, 1974, to monitor the industry's response in compliance with the foregoing consensus.

(3) Continue to explore in conjunction with the other NAIC subcommittees working in this area other long-range methods of encouraging proper sales and reducing lapses.

The adoption of the foregoing suggestions would have the effect of clearly informing the industry what is expected of them in complying with Art. III Sec. 3 without destroying the flexibility required for imaginative responses to this problem in the absence of any marketing experience with the product.

Respectfully submitted,

Michael W. Kessler

Michael W. Kessler

The Articles referred to in the text of the memorandum are attached to the copies sent to members of the (C4) Subcommittee. They are:

Research On Persistancy, Life Insurance Agency Management Association (1960).

"Conservation at the Point of Motivating the Agent;" Donald H. Bender, Texas Life Convention, April 16, 1971.

Profitable Selling, Life Insurance Agency Management Association (1973).