LIFE INSURANCE (C3) SUBCOMMITTEE

Reference:
1977 Proc. Vol. I p. 478
1977 Proc. Vol. II p. 494

Hon. Dick L. Rottman, Chairman – Nevada
Hon. Maximilian Wallach, Vice-Chairman – District of Columbia

AGENDA

1. Report of the Technical Task Force on Standard Nonforfeiture and Reserve Valuation Laws.
2. Report of the Life Insurance Cost Comparison Task Force on the study of life insurance dividend practices, annuity disclosure and life insurance policy lapsation.
3. Report of the Life Insurance Agent's Compensation Task Force.
4. Report of the Life Insurance Replacement Regulation Task Force.
5. Report of Task Force to Study and Develop Standards for Life Insurance Policy Language Simplification.
6. Any other matters brought before the subcommittee.

The Life Insurance (C3) Subcommittee convened on Wednesday, December 7, 1977, at 9:00 a.m. in Napoleon I, Deauville Hotel, Miami Beach, Florida. The meeting was chaired by Commissioner Dick L. Rottman of Nevada, and a quorum was present.

The report of the Life Insurance Cost Comparison Task Force was given by Erma Edwards of the Nevada Department. This task force is currently studying policy lapsation, dividend practices and annuity disclosure. Mrs. Edwards asked the (C3) Subcommittee to approve the amendment of a clerical error in the NAIC Model Life Solicitation Regulation printed in the 1976 Proceedings, Volume II, page 551. The clerical error involved the omission of the word "only" from the sentence, "It will be worth your time to try to understand how these indexes work but in any event use them only for comparing the relative costs of similar policies." The report was received (attached) and the recommendation to amend the Proceedings was adopted.

The American Council of Life Insurance presented the task force with an update by states of the current status of the NAIC Model Life Insurance Solicitation Regulation which was attached to the Cost Comparison Task Force report. Commissioner Herbert Anderson of Iowa urged the adoption by all the states of the Model Life Insurance Solicitation Regulation promulgated by the NAIC. He pointed out to the Commissioners the current action on this subject being taken by the federal government.

Chairman Rottman called on Paul S. Epstein, Federal Trade Commission to speak briefly on current federal interest in this area. Mr. Epstein reported that although their investigation was nonpublic, he estimated that there would be a regulation promulgated by the Federal Trade Commission, possibly by the end of the summer. It was his feeling that this proposed regulation would be submitted to the Commissioners for their use as an alternative measure to the NAIC model, rather than as a Federal Trade Commission order on this point, but they had not made a final decision. He said that within the next few months, a life insurance buyer's guide and summary sheet prepared by the Federal Trade Commission would be sent to each of the states.

The report of the Life Insurance Agents' Compensation Task Force was given by task force chairman, Dick L. Rottman of Nevada. Commissioner Rottman reported the task force had met in Boston on October 7 in a joint meeting with the industry advisory committee. Two reports previously prepared by the industry advisory committee were reviewed at this time. The task force concurred substantially with the industry advisory committee reports. The present agent compensation system, Mr. Rottman stated, is sufficiently complex that the implications of tinkering with the system through a system of agency controls appeared to be of questionable customer value. To impose a regulation at this time probably would be more cosmetic than real as a life insurance cost cutting device. After thoroughly discussing all aspects of the subject, the task force concluded it was not feasible to develop a model regulation covering expense limitations. Chairman Rottman asked that the Life Insurance Agents' Compensation Task Force be dismissed. The report was received and adopted (attached) and the task force discharged.

Director Berri Balka, Chairman of the Life Insurance Replacement Regulation Task Force, gave his report. He noted a model replacement regulation has been submitted to the (C3) Subcommittee and is attached to his report as an exposure draft.

Ronald J. Doane, Chairman of the industry advisory committee spoke briefly on the committee's work in helping prepare the exposure draft. Mr. Doane stated there were two corrections to be made in the exposure draft. In the last sentence of the sixth paragraph of comments on Section 9, the word "annually" should read "manually." In Section 4b of the draft, the word "policy" should be deleted and the words "existing life insurance" should be added. Director Balka asked that comments on the exposure draft regulation be sent to him by January 1978 so a task force meeting to review these comments could be held the first part of February 1978. The report was received by the subcommittee. The report and amended draft are attached.

Commissioner Woodyard, Chairman of the Life Insurance Policy Language Simplification Standards Task Force gave his report, the first of this task force. The report is attached. Commissioner Woodyard stated the task force hoped to have a model bill ready for the June 1978 meeting.

Commissioner Herbert Anderson of the Iowa Department suggested that the last sentence of this report might be misinterpreted, so the report was received with the deletion of the last sentence.

Richard Minck of the American Council of Life Insurance asked the subcommittee to consider a set of amendments to the NAIC Model Group Life Insurance Law. The present model group life insurance statute is now 20 years old and the amendments, he said, would make the bill more responsive to current day needs.

A motion was adopted to appoint a task force to review the amendments submitted by Mr. Minck and to consider similar amendments to the group health law. The report submitted by the Council are attached.

John Montgomery of the California Department, Chairman of the (C) Technical Task Force on Standard Nonforfeiture and Reserve Valuation Laws presented its report. The model valuation and nonforfeiture value legislation adopted by the NAIC at the December 1976 meeting provided for a six-year age setback for females. The task force, in its November 1977 "special" report, recommended adoption of the modifications to the 1958 Commissioners Standard Ordinary Mortality Table to provide for the six-year age setback for females at ages under 20. Mr. Montgomery's report was received and the six-year age setback for females was adopted. The task force's November and December reports are attached.

Having no further business, the subcommittee adjourned at 10:30 a.m.

Hon. Dick L. Rottman, Chairman, Nevada; Hon. Maximilian Wallach, Vice-Chairman, District of Columbia; Hon. W.H.L. Woodyard III, Arkansas; Hon. J. Richard Barnes, Colorado; Hon. Herbert W. Anderson, Iowa; Hon. Edward J. Birrane Jr., Maryland; Hon. Jerry B. Buxton, Missouri; Hon. James J. Sheeran, New Jersey; Hon. Peter F. Mullaney, Rhode Island; Hon. Roger C. Day, Utah; Hon. John G. Day, Virginia.

Life Insurance Cost Comparison (C3) Task Force Report

St. Louis, Missouri
November 9-10, 1977

The Life Insurance (C3) Cost Comparison Task Force met November 9-10, 1977 in St. Louis, Missouri. The task force is currently studying life insurance policy lapsation, dividend practices and annuity disclosure regulation. The first of these topics discussed was the life insurance policy lapsation study.

The original task force on policy lapsation was given the charge to respond to five specific questions, as follows:

1. What is the extent of the problem of lapsation?

2. What is the source of lapsation?

3. What is the effect of early lapsation on rates charged with continuing insureds?

4. What is the extent of financial loss to consumers where high lapse rates exist?

5. What feasible solutions can be found?

The task force reviewed the questions and feels they form a sound basis for a beginning study. Additionally, it was suggested the first question to be considered should be to identify whether or not a lapse problem exists. The suggestion was accepted and the five questions will be the subject of the study. An industry advisory committee, chaired by the Life Insurance Marketing Research Association (LIMRA) will be appointed to begin the study. The advisory committee was requested to provide a progress report to the task force for review prior to the June 1978 meeting and to consider a possible final report prior to December 1978.

Dick Minck of the ACLI presented an update by states of the current status of the NAIC Model Life Insurance Solicitation Regulation. This report is attached.

An interim report prepared by the Society of Actuaries Committee on Dividend Philosophy was presented by Bart Munson representing the Society Committee members. Mr. Munson reported the Committee believed it could develop guidelines to be used by company actuaries for presentation to the task force within the next year. It was suggested by Jack Moorhead that the committee prepare a statement of its current progress and a tentative date for completion of the final report. The task force accepted this suggestion and asked the committee to provide such a statement. The statement and the interim report are attached.

A model annuity and deposit fund disclosure regulation was submitted by the American Council of Life Insurance for consideration by the task force. After review and suggested amendments by the members, it was decided to attach the amended regulation as an exposure draft for further comment by interested parties.

The task force was informed by the NAIC Central Office of a clerical error in the final printing of the Life Insurance Solicitation Regulation.

The error is to be found in the 1976 Proceedings of the NAIC Vol. II, page 551 under the heading, "Finding a Low Cost Policy." The next to the last sentence of that paragraph reads, "It will be worth your time to try and understand how these indexes are used, but in any event, use them for comparing the relative costs of similar policies." The task force recommends the Proceedings be amended to add the word only following the words,"in any event, use them" to the sentence to correct this error. The corrected sentence should read, "It will be worth your time to try to understand how these indexes are used, but in any event, use them only for comparing the relative costs of similar policies."

The task force report at the December 1975 NAIC meeting identified 11 additional matters which it believed needed further study. These proposals which are to be found in the 1976 Proceedings of the NAIC Vol. I, page 523, were reviewed at the November meeting.

It is recommended by the task force that some of the original proposals be eliminated as they have either been assigned to separate task forces, will be resolved through the functions of other relevant studies or are already provided for under various state statutes. The task force felt that seven items including the three currently under consideration should be retained for further study. These include the following:

1. A study of methods of detecting manipulation of policy values and dividends in such a way as to produce unrealistically attractive cost indexes.

2. Development of appropriate regulation of dividend illustrations.

3. A study of the need for a separate disclosure system for group insurance, credit life insurance, annuities and variable life insurance.

4. A study of the feasibility of developing a more extensive disclosure system which would be made available upon request, including a system which would be applicable to dissimilar policies.

5. A study of the need for modification of our disclosure system to accommodate special subgroups of the life insurance buying public, including veterans, college students and senior citizens.

6. A study of the feasibility of developing a central data bank cost comparison information.

7. A study of the need for developing alternate systems of improving the general public's understanding of the life insurance product through means other than point of sale disclosure.

The two-day meeting was adjourned at 4:00 p.m., Thrusday, December 10, 1977.

To: Richard V. Minck

From: Jack H. Blaine

Date: November 8, 1977

Re: Status of NAIC Model Life Insurance Solicitation Regulation

Our state legislative directors and associates have compiled reports on the status of implementation of the NAIC Model Life Insurance Solicitation Regulation. The following is a summary of action to date and prognosis of future action:

I. States Adopting 1973 Interim Model Regulation (IA -- 4% assumed interest)

Arkansas
California
Oregon
Pennsylvania
Texas
Wisconsin

II. States Adopting 1973 Deceptive Practices Regulation Only (Prohibits use of any system or presentation for comparing cost of life insurance that does not recognize the time value of money)

Kansas
West Virginia
New York (Not the Model, but prohibits use of traditional net cost method and permits alternate methods that recognizes time value of money.

III. States With Current (1976) Model Regulation

Iowa (1/1/78)
New Jersey (1/1/78 -- Buyer's Guide 2/1/77)
Arizona (1/1/79)
New Hampshire (4/1/78)
Connecticut (1/1/78)

IV. Hearings Held on Current (1976) Model, Not Yet Adopted

Nebraska
North Carolina
Oregon (See Category I, above)
Wisconsin (See Category I, above)

V. Model Regulation Currently Under Serious Consideration

California (See Category I, above)
Georgia
Indiana
Kentucky
Montana
New Mexico
Texas (See Category I, above)
Vermont

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To: Life Insurance Cost Comparison (C3) Task Force

From: J. Edwin Matz, President and Chief Operations Officer
John Hancock Mutual Life Insurance Company
200 Berkeley Street
Boston, Massachusetts 02117

Date: November 21, 1977

Re: Supplement to the interim Report of Our Committee on Dividend Philosophy and the November 10 Discussion in St. Louis

Since our committee's formation last year, we have held nine formal committee meetings and numerous other discussions. The subject is complex. It has few responsible answers that one can quickly achieve. Yet much progress has been made. To share that progress and help chart our future course, we felt it desirable to expose our thinking to the full membership of the Society, plus other interested parties, by means of the interim report.

That report contains the following suggested conclusions which, I believe, are of interest to you:

1. "The Committee . . . decided negatively on the use of illustrated dividends based on either historical data, representing past performance, or on projections of future performance . . ."

2. "The decision was reached to attempt to improve the handling of dividend illustrations based, as they have been, on current dividend scales."

3. "The Committee ultimately decided that the attractive idea of reconciling paid and illustrated dividends by some statistical process is probably unworkable in practice and cannot easily be used as the basis for enforcing discipline in the dividend illustration process."

4. "(The Committee) believes that what has been demonstrated is that dividend practices require the exercise of skilled professional judgment, the results of which are neither unique nor amenable to rigid prescription."

5. "(The Committee) believes that the ultimate solution must lie in the formulation of Guides and Opinions as provided for under the constitutions of the Society and other actuarial organizations. It further believes that such Guides and Opinions will necessarily extend somewhat beyond the area of dividend illustrations to aspects of dividend allocations – a conclusion reached with some, but not total, reluctance."

As to the perceived future course of the Committee's efforts, the report indicates that:

> "It is a natural conclusion that actuarial organizations have a duty to recognize and strengthen the basis on which individual actuaries perform those (dividend allocation, payment and illustration) tasks through the formulation of appropriate Guides and Opinions relating to conduct in this area."

The report was widely discussed at the Society's Annual Meeting in Boston on October 24, in one concurrent session and three workshops. The conclusions reached and the direction the committee describes for its immediate future work were supported by the Society's membership there assembled.

A subcommittee is currently pursuing a draft of the Guides and Opinions, along the lines outlined in our interim report.

Our next committee meeting is January 12, and I envision we'll continue to meet at least quarterly during 1978. I expect that a second report would be achievable in late 1978. It would contain suggested positions on several issues and, most importantly, a rather complete and specific draft of recommendations for actuaries to be guided by in dividend activities. I hestiate to describe that second report as a final report, for the nature of the subject – both its complexity and its importance – will undoubtedly require continuing discussions within the actuarial profession, as well as the life insurance industry and its regulators. By their very nature, research and pronouncements along the lines we are pursuing – guides to professional conduct and their supporting opinions and recommendations – indeed require continuing scrutiny and modernizing, once established, and not a label of "finality."

The December 9, 1975 list of items "in need of further study" identified by your task force includes:

> "3. Development of appropriate regulation of dividend illustrations."

While we do not see that our committee's proper purview includes the drafting of such regulation, or even the determination of whether such is needed or desirable, we do see our work directly related to that statement. Hopefully our work results will be useful to the NAIC in discharging its regulatory responsibilities. In fact, our interim report states:

> "(The drafting of Guides and Opinions) would not be wholly unrelated to questions of regulation. Probably some related actions would be appropriate there:
>
> 1. Those states which do not have adequate statutes or regulations relating to dividend illustrations could improve what they have.
>
> 2. Schedule M could be improved.
>
> 3. An actuarial certificate might be devised to confirm use of proper methods in handling dividend matters."

To that end, we anticipate discussions with you and others representing the NAIC as our efforts continue to produce results and the next report is released.

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To: Board of Governors and the Society of Actuaries

From: Committee on Dividend Philosophy (Special)

Date: Fall 1977

Re: Interim Report by Committee on Dividend Philosophy

This committee was appointed March 1, 1976 with the charge as quoted here:

> The purpose of this committee is to (1) study in depth the underlying actuarial principles and practical problems relating to the calculation and illustration of dividends, including related matters of philosophy, and (2) to develop a report on its findings and recommendations.

The intent of the language was to give the committee broad latitude in pursuing its investigations. It was understood, however, that the assignment related only to individual life insurance and annuities.

Since its first meeting in April 1976, the committee has met at roughly two-month intervals, and members have carried out numerous assignments between meetings. The subject has turned out to be an extremely difficult one. Final recommendations will not be ready for some time to come. However, a good bit of ground has been covered and some conclusions have been arrived at. The committee feels that it would be helpful to describe its present position, and how it got there, and to seek interaction with the membership of the Society with regard to both its past activity and its future plans. This is the purpose of this interim report. To that end it is requested that the report be exposed to the membership of the Society with no implication that it has been reviewed or adopted by the Board.

In the work of the committee to date, members have had the assistance of many of their colleagues, too numerous to mention here. However, the contribution of two actuaries, who are not committee members, should be especially noted: Richard V. Minck, who sat with the committee as liaison with insurance company organizations and Franklin E. Peters, who functioned as committee secretary.

Members of the Special SOA Committee on Dividend Philosophy: J. Edwin Matz, Chairman; Harry D. Garber; Russell R. Jensen; Edwin B. Lancaster; Robin B. Leckie; Richard S. Miller; Robert A. Miller; Bartley L. Munson; William A. Spare; Thomas C. Sutton; Julius Vogel (effective June 1977); Jack T. Kvernland (to June 1977).

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Report Outline

Summary of Actions and Conclusions

To define the scope and importance of various aspects of its assigned mission, the committee reviewed the concerns that have been expressed in recent years about dividend practices. A reasonably comprehensive exposition of that history is set out in Appendix A to this report under the heading, "Cause for Appointment."

The range of the concerns is broad. The following list is not exhaustive:

1. Whether dividend illustrations are handled with sufficient uniformity to make cost comparisons valid.

2. Whether dividend distributions meet adequate standards relating to equitable treatment of policyholders.

3. Specifically whether competitive pressure influences companies to favor new policyholders at the expense of old policyholders.

4. More specifically, whether investment generation methods should be allowed for individual life insurance.

5. Whether dividend practices are adequately disclosed to the various interested publics.

Without having made a detailed assessment of the validity of the criticism, the committee felt there were cogent reasons to react. What needs defense should be defended; if reform is needed, the actuarial profession should take the initiative in it; if regulation is appropriate, the actuarial profession should fill a key role in devising it.

As a matter of principle, the committee believes that whatever constraints are placed on the dividend process should preferably require disclosure of practices rather than prescribing a narrow range of allowable practices. Reasonable diversity in the making of the many judgments required has been and should continue to be encouraged. Then, too, the process of change may well turn out to be an evolutionary one in which disclosure is needed first to determine the direction of further action.

Since the problems were related so heavily to the recent increased emphasis on cost comparison, first efforts were aimed at improvement in the area of dividend illustrations, as distinguished from the related, but much broader field of dividend apportionment. The chapter, "Basis of Dividend Illustration," describes the alternate approaches considered and the reasons why they were ultimately rejected. The decision was reached to attempt to improve the handling of dividend illustrations based, as they have been, on current dividend scales.

The greatest amount of effort to date was expended on work described in the succeeding chapter, "Efforts to Define and Measure Appropriateness of Relationships Between Illustrated and Paid Dividends." The attractiveness of any solution that might be found along these lines was so great that several variations of this basic idea were pursued at length; it was only with great reluctance that the committee decided such an approach was not feasible.

Essentially, the work to date has resulted in negative conclusions. However, the committee believes it has narrowed the options. It believes that the ultimate solution must lie in the formulation of guides and opinions as provided for under the constitutions of the Society and other actuarial organizations. It further believes that such guides and opinions will necessarily extend somewhat beyond the area of dividend illustrations to aspects of dividend allocations -- a conclusion reached with some, but not total, reluctance. The reasoning behind these conclusions is set out in the final chapter, "Probable Future Courses of the Committee Work," along with an enumeration of several subsidiary topics on which the committee is not yet ready to make recommendations.

Finally, to provide a basis for discussion and reactions, "Appendix B" sets out two very tentative approaches to the task of formulating guides and opinions. These are for illustrative purposes only to stimulate discussion of the concept. They do not represent considered recommendations of the committee.

Basis of Dividend Illustrations

The total field of dividend practice is vast, and the potential for harm of unnecessarily restrictive actions is large. As a matter of principle, the committee approached its task feeling that if requirements are to be imposed, they should be aimed primarily at disclosure rather than at restriction of practice -- at least until such time as acceptable practice can be more adequately defined. It is recognized, however, how frequently disclosure is only a prelude to prescription or proscription.

For analogous reasons, the committee felt it desirable to avoid affecting the area of dividend allocation -- in which company managements have had broad discretionary authority and corresponding responsibility -- if the current concerns could be satisfied by actions dealing with dividend illustrations. It's initial investigations, therefore, dealt with dividend illustration practices as distinguished from dividend allocation practices.

The buyer of a participating policy clearly has a need for and a right to some sort of dividend information. Ideally, he would like to know precisely what the dividends will be. But if they are to serve the fundamental purpose of adjusting the policyholder's cost to evolving experience, they will not be that predictable. Nevertheless, it should be possible to indicate to him when dividends may start, of what magnitude the first dividends will be and how rapidly they might be expected to increase.

Whatever rules may apply, illustrated dividends should reflect the performance of the insuring company for the policy under consideration. This should be true in a relative, as well as an absolute, sense if the buyer wishes to compare costs of two or more policies. If Company A out-performs Company B, by some theoretically appropriate measurement technique, the cost comparisons resulting from its dividend illustrations should reflect that fact.

One possible approach would be to limit illustration of dividends to those actually paid on corresponding policies in past years (with any composite index computed on an interest-adjusted basis, of course). The resulting historical net costs would certainly reflect performance accurately. However, the prospective buyer would be interested in future performance, not past. Still it might be argued that past performance will most often presage future performance. On those grounds, the use of historical costs might be defended in an era when they tended to remain stable for several decades.

However, today's buyer should surely dismiss historical costs as not relevant to his problem. The policy he would have under consideration would most likely have a significantly different premium and cash value structure from the one illustrated in the history. Furthermore, it could be made very apparent very quickly that the absolute differences in net cost, however calculated, between old and new policies, would be very large. Surely there must be some more appropriate basis.

At the other extreme of the time spectrum is where the buyer's interest lies: future performance. Why not give him the actuary's best guess at the dividends that will evolve from future changes in experience factors? Precisely this has been proposed by some serious students of the problem, including both skilled technicians and experienced regulatory officials.

The obvious difficulty is that of discipline. The range of possible future variation of any one experience factor is quite large. Scatter diagrams of forecasts of interest rates on new investments, mortality levels and expense rates five or ten years from now would exhibit only modest consistencey, even if all the forecasters were highly skilled. The actuary's approach to forecasting in matters affecting premiums or dividends, has traditionally been to limit extrapolation of current epxerience trends to the short interval until the planned rate schedules will produce cash flow and, beyond that time, to make any assumptions on the conservative side. The pressures of competition bear on that work habit, of course, with varied results.

Those who propose the use of projected dividend illustrations obviously are aware of the discipline question. Generally, they propose that restraint can be enforced by establishing a system to compare forecasts with actual dividends as they evolve year by year. In the opinion of the committee, this is simply not adequate. A possible future penalty is seldom an effective deterrent to an action that may bring real advantage now. The range of future variations in experience factors is substantial. The impact of small differences in forecasting those factors on projected dividend scales could easily be very significant in terms of comparative costs. The pressure on the ratemaker to make his forecasts as favorable as possible would be considerable. And what opprobrium would attach to a difference that developed between forecast and actual dividends? Would not such differences, small or large, positive or negative, almost always be assumed to reflect an unforeseeable change in experience rather than biased forecasting?

The statutes and regulations which represent sentiment of the regulators seem to be most concerned about overly-agressive selling. Illustrated dividends may not be "guarantees" or "estimates," although it is true that in most cases states specifically prohibit estimates only described as "misleading." More positively, significant state statutory language requires that illustrated dividends be based on "the current dividend scale," or "based on assumptions of the policy and dividend scale in actual use." For some decades this principle ruled with general satisfaction. It is only in recent years that discontent appeared as to its operation.

The committee, having decided negatively on the use of illustrated dividends based on either historical data representing past performance or on projections of future performance, was left to seek some middle ground. The obvious candidate is a system of illustrated dividends based on company performance now, which effectively translates into one based on current dividend scales – the very system about which there is currently much discontent. The deficiencies of the approach have been well exposed by recent studies. They seem to fall into two categories:

1. The public cannot readily understand the nuances of definition in the approach. In spite of careful warnings, buyers will frequently assume that dividend illustrations are "guarantees" or "estimates." This has not been a problem over the long span of constantly improving dividend scales, but would undoubtedly provoke difficulties in a period of deterioration.

2. The concept of dividend illustration based on current dividend scales is not as rigidly defined and free from abuse as we once may have thought. Undoubtedly, many of the present concerns flow from the vastly increased emphasis on price comparison of life insurance products, but there is no sign that that tide will ebb soon.

The possible use of investment-year methods in dividend illustrations compounds both of these types of difficulties.

These are not trivial problems, but they may be soluble. The committee turned to examine the possibility of better definition and improved discipline of the current approach to dividend illustration.

Efforts to Define and Measure Appropriateness of Relationship Between Illustrated and Paid Dividends

What is meant by dividend illustrations "based on the current dividend scale" or "based on the policy and dividend scale in actual use?" If a company's current rate structure has been in use for a number of years, a part of the problem is simple to agree on: the dividends illustrated for the early policy years should be the same as those that are currently being paid to identical policies. In a time of stable experience, this could become almost a complete answer. In recent times, however, policy series have had short lives. For most life insurance sold today, the premium, cash value and other benefit structures have been in use only a few years. What about the dividends illustrated for durations beyond that point?

At an early stage the committee concluded that the most significant possible step toward proper discipline of dividend illustrations would be to extend to dividend illustrations the same financial constraints that apply necessarily to dividends paid. This endeavor was put into words at one of the first meetings along these lines: "dividends illustrated should be compatible with dividends actually paid, having due regard to differences in premium and benefit structures of the policies concerned." The same idea was expressed numerous times later, both by committee members and others. One approach was in these words: ". . . .dividend illustrations faithfully portray what the company is now paying on its policies in force, duration by duration, adjusted only for differences in premiums, surrender values and benefits."

A different approach with the same end in view proposed requiring that illustrated dividends be based on the same experience factors as dividends currently paid, with satisfactory rationalization being furnished wherever this was not so. Several members devoted a considerable amount of effort toward developing this approach. It eventually was set aside for two reasons:

1. The approach seemed to lead inevitably into an attempt to define acceptable treatment of experience factors in the dividend apportionment process, an area which at that time the committee was attempting to avoid.

2. When actuaries do introduce differentials in mortality, interest or expense rates, they usually do have reasons which they are willing to support as sound and appropriate. Enforcement of any code based on this approach would tend to degenerate into a process of passing judgment on an unpredictable variety of such rationalizations.

What these lines of thought suggest is the concept of a statistical test that would measure the appropriateness of the relationship between dividends illustrated and dividends paid. Such a thought has great intuitive appeal -- and corresponding durability. If such a measurement were possible, a variety of approaches to disclosure and possibly regulation could be considered:

1. A satisfactory reconciliation over a suitable network of plans, ages and durations could be required to validate a company's illustrated dividend scales. Illustrated dividend scales which failed the test would be disallowed.

2. A company's illustrated dividends could be tested over such a network with satisfactory explanation being required whever the reconciliation failed to demonstrate differences within defined limits of acceptability. This modification would better fit the committee's inclination to rely more on disclosure than on prescriptive regulation.

3. The paid dividends, suitably "adjusted," could be used directly as a new approach to dividend illustration. The obvious drawback is that the illustrated dividend would then relate more distantly to the policy being considered for purchase. On the other hand the method would have the virtue of imposing simultaneous discipline on the dividend apportionment as well as the illustration process.

Because of changes in benefits, premiums and dividends, any of these possible approaches would require development of some method of "adjusting" paid dividends for direct comparison with illustrations or else a net cost comparison, as described below, would have to be devised. It is worthwhile to follow the process of adjusting the dividend paid at a given duration for differences in premium and benefit structure, to compare the result with a corresponding illustrated dividend. If we let D = annual dividend, AD = adjusted dividend, G = gross premium, $\overline{CV}$ = cash value and superscripts p & i denote paid scale and illustrated scale, then in the case where there has been no change in cash value schedules, we would have:

$$AD = D^p + G^i - G^p$$

This straightforward result would be readily accepted except for minor carping about failure to allow for percent-of-premium expenses. When the cash values have changed, however, there would be less agreement to:

$$AD = D^p + G^i - G^p + \triangle \overline{CV}^p - \triangle \overline{CV}^i$$

It would be noted that earnings from interest included in the dividends are a function of accumulated assets, earnings from mortality are a function of the net amount at risk, and these parameters depend on reserve bases and cash values. Earnings from loading, like the annual increase in cash value, are dependent on the decisions made as to the period for recovery of initial expenses and are not likely to be readily reconcilable for a single duration, as between two different policy series. Then too, some modification should be made to accommodate the effect of changed average sizes on earnings from loading.

To follow through the process to its legitimate end, the committee analyzed procedures which would allow for the differentials cited here. The resulting adjustment formulas were quite complex, not as related to common actuarial mathematics, but viewed as something to be comprehended by insurance buyers and regulators. Furthermore, they would have to be augmented by alternates for companies which use dividend formulas other than the common three factor approach.

Even with all these refinements, the adjustment process would not reflect differences in pricing practice resulting from such things as different policy loan rates, introduction of separate male and female rates, changes in amount bands, revised underwriting standards, etc. Modifications could theoretically be made for these factors, but they would require modifying the adjustment formula to allow the individual actuary to enter into it his own estimate of the impact of such changes on investment yield, mortality and expenses.

In the end the committee felt that a process of adjusting paid dividends to reflect the cost and benefit structures of the current series of policies would require adjustment formulas too complex to be usable for the purposes contemplated. The alternate choice of arbitrarily keeping the adjustment formula simple would not be fair, nor would it be practical. The buyer of a newly introduced high minimum preferred risk policy would want illustrations appropriate to his policy, not "adjusted" figures from one both old and different.

A second approach to the reconciliation process was examined at length by the committee. If the illustrated dividends and paid dividends are both based on the same current experience, should it now follow that the prospective net cost indexes are compatible? For example, should not the interest-adjusted cost index over that period contemplated under the current paid dividend scale for a policy issued ten years ago? To test this thesis, the committee collected a set of data covering sample plans and ages from their own companies.

In addition, a second, somewhat comparable, approach was used. The second approach was based on the fact that the numerator of the formula for the interest-adjusted cost index

$$(IA)_n = \frac{\sum_{t=1}^{n} C_t(1+i)^{n-t}}{\ddot{s}_{\overline{n}|i}}$$

can be broken down into separate terms representing cost of insurance C_t for each policy year

$$C_t = (CV_{t-1} + G)\ (1+i) - (CV_t + D_t)$$

This suggests constructing what might be called a "cross sectional cost index" for a given policy made up from the paid dividends of the current calendar year (e.g. the third year dividend on policy issued three years ago, the fourth year dividend on a policy issued four years ago, etc.) and comparing the result with current illustrated cost indexes for new policies. The comparison could be either year by year or over a span of years. Again, data were collected from the committee members' own companies to test the results.

For either of these two procedures, there were two possible approaches for use. If there were satisfactory support in both theory and practice, one could visualize a requirement that cost indexes derived from paid dividends vs. those derived from illustrated dividends coincide within some prescribed tolerance for a network of plans, ages and durations. More likely, the disclosure principle would simply require satisfactory explanation (e.g. in some sort of actuary's certificate) where the deviations fell beyond the prescribed range.

There are only a handful of companies represented on the committe and they are of such size that the technical skills available for dividend work should be at optimum levels. However, even for this small and favorable sample, the differences exhibited by the statistical tests described above were larger and far less predictable than might have been expected intuitively. Exhibits A1, A2, B1 and B2 show the types of differences developed for just a few of the policies tested.

The definition of an allowable margin of difference, as a percentage of either premium or the cost index itself, posed great difficulty. With no theoretical basis, any choice must be arbitrary. Then too, what might be suggested by the committee as a criterion for requiring actuarial explanation could quite readily be transformed by regulatory authority into rigid limits.

Exhibit A1: Prospective Cost Index -- Selected Groups of Durations
Whole Life -- Male Issue Age 25 – 5% Loan Interest Rate
Basis of $1,000 for Face Amount of $20,000

Groups of	Policy 1		Policy 2		Policy 3		Policy 4	
Durations	Index (I)	Index (P)	Index (I)	Index (P)	Index (I)	Index (P)	Index (I)	Index (P)
1-10	6.19		5.94		3.89		4.54	
1-20	4.96		4.61		3.38		3.53	
6-10	2.98	2.98	2.15	2.58	.65	1.59	−0.11	2.28
6-20	2.97	2.97	2.32	2.53	1.75	2.03	1.06	3.19
11-20	2.95	2.66	2.44	2.49	2.54	2.68	1.89	3.26
16-20	3.33	3.08	2.38	3.15	2.41	2.78	1.80	4.04

Index (I) – Interest-adjusted (5%) prospective cost index for policies issued in 1977, using illustrative dividends according to 1977 dividend scale.

Index (P) – Interest-adjusted (5%) prospective cost index for existing policies that are now entering the earliest duration of each prospective duration group -- i.e. 1972 issues for duration group 6-10; 1967 issues for duration group 11-20; and 1962 issue for duration group 16-20.

Exhibit A2: Prospective Cost Index -- Selected Groups of Durations
5-Year Renewable-Convertible Term -- Male Issue Age 45
Basis of $1,000 for Face Amount of $20,000

Groups of Durations	Policy 1 Index (I)	Policy 1 Index (P)	Policy 2 Index (I)	Policy 2 Index (P)	Policy 3 Index (I)	Policy 3 Index (P)	Policy 4 Index (1)	Policy 4 Index (P)
1-10	10.41		10.79		9.10		8.64	
1-20	14.56		14.56		12.80		12.21	
6-10	11.91	11.70	11.99	13.79	10.06	8.50	10.44	10.50
6-10	17.39	17.33	17.06	19.01	15.18	12.82	14.86	14.68
11-20	21.31	20.98	20.69	22.75	18.85	15.86	18.02	15.51
16-20	26.33	26.04	25.61	28.64	23.52	21.87	20.62	18.90

Index (I) -- Interest-adjusted (5%) prospective cost index for policies issued in 1977, using illustrative dividends according to 1977 dividend scale.

Index (P) -- Interest adjusted (5%) prospective cost index for existing policies that are now entering the earliest duration of each prospective group -- i.e. 1972 issues for duration group of 6-10; 1967 issues for duration group 11-20; and 1962 issue for duration group 16-20.

Exhibit B1: Cross Sectional Cost Index -- Yearly Basis
Whole Life -- Male Issue Age 25 -- 5% Loan Interest
Basis of $1,000 for Face Amount of $20,000

Duration	Policy 1 Index (I)	Policy 1 Index (P)	Policy 2 Index (I)	Policy 2 Index (P)	Policy 3 Index (I)	Policy 3 Index (P)
1	18.02	18.02	17.27	17.27	15.88	15.88
2	14.95	14.95	15.44	15.44	5.69	5.69
3	3.65	3.65	7.16	7.16	3.79	3.79
4	3.90	3.90	2.23	1.93	3.62	1.57
5	3.13	3.13	2.54	3.40	3.46	1.50
6	3.42	3.42	2.80	2.78	0.75	1.45
7	3.71	3.15	2.09	3.22	0.72	1.38
8	2.90	2.34	2.44	2.68	0.67	1.30
9	3.14	2.57	1.75	3.15	0.63	1.24
10	2.37	2.77	2.11	1.58	0.60	3.12
11	2.64	2.18	1.48	1.99	3.08	2.96
12	2.89	2.38	1.93	2.31	2.91	2.80
13	2.13	4.66	4.35	1.98	2.75	2.66
14	2.74	2.08	1.56	3.15	2.60	2.56
15	3.65	3.27	3.98	3.38	2.51	2.68
16	3.79	3.45	2.35	2.53	2.46	2.75
17	2.99	2.69	1.80	3.42	2.41	2.83
18	3.27	3.02	2.36	3.26	2.50	2.93
19	3.57	3.35	2.85	4.61	2.61	3.03
20	3.91	3.70	3.27	3.90	2.72	3.19

Index (I) -- Interest-adjusted (5%) cross sectional cost index for policies issued in 1977, using illustrative dividends according to 1977 dividend scale.

Index (P) -- Interest-adjusted (5%) cross sectional cost index for existing policies in force at specified policy durations, using dividend payable at that duration in 1977.

Exhibit B2: Cross Sectional Cost Index – Yearly Basis
5-Year Renewable-Convertible Term – Male Issue Age 45
Basis of $1,000 for Face Amount of $20,000

	Policy 1		Policy 2		Policy 3	
Duration	Index (I)	Index (P)	Index (I)	Index (P)	Index (I)	Index (P)
1	9.91	9.91	11.13	11.13	9.50	9.50
2	9.91	9.91	10.25	10.25	8.76	8.76
3	9.91	9.91	10.25	10.25	8.61	8.61
4	9.91	9.13	10.07	11.31	8.46	9.88
5	8.72	8.42	9.89	11.13	8.31	9.62
6	12.71	12.85	13.87	15.59	10.90	9.37
7	12.57	12.25	13.40	15.18	10.74	9.12
8	12.44	11.94	12.48	14.38	10.56	8.89
9	12.41	11.66	11.56	13.58	10.36	8.67
10	12.38	11.41	11.33	13.38	10.15	8.51
11	18.31	18.30	17.67	19.64	16.41	18.82
12	18.28	18.05	17.67	19.64	16.18	18.17
13	18.25	17.83	17.67	20.36	15.94	17.53
14	18.20	17.62	17.67	20.36	15.68	16.90
15	18.14	17.42	17.67	20.36	15.38	17.81
16	27.96	28.10	26.89	30.06	25.27	19.29
17	27.90	27.73	26.89	30.06	24.97	20.95
18	27.84	27.34	26.89	30.81	24.67	22.86
19	27.42	26.91	26.89	30.81	24.37	25.23
20	26.99	26.43	26.89	30.81	24.07	27.80

Index (I) – Interest-adjusted (5%) cross sectional cost index for policies issued in 1977, using illustrative dividends according to 1977 dividend scale.

Index (P) – Interest-adjusted (5%) cross sectional cost index for existing policies in force at specified policy durations, using dividend payable at that duration in 1977.

If such approaches pose problems for the companies represnted on the committee, it is not hard to imagine the magnification of the difficulties that would be encountered when they are applied to 100 and more companies. The committee ultimately decided that the attractive idea of reconciling paid and illustrated dividends by some statistical process is probably unworkable in practice and cannot easily be used as the basis for enforcing discipline in the dividend illustration process.

But what does that imply? Does it mean that dividend practices of life companies generally are inequitable, distorted by competitive pressures? Some thought was given to the reasons why the results were as they were. Part of the explanation lies in the refinements of pricing policy that were introduced over recent decades referred to earlier. Part of the reason lies in the evolution of experience over time. The mortality, lapse, etc. experience of one series of policies will differ from another, as times and practice change.

A fundamental reason seems to lie in the basic approach to price structures. When premiums, cash values and dividends are planned for a new series of policies, the actuary normally sets a surplus objective at the end of some period, say twenty or thirty years. The pattern of asset accumulation which will meet that objective is capable of infinite variety, depending on slopes of cash value schedules and steepness of dividend scales. Furthermore, surplus objectives can only be met on averages, not for each plan, age and amount. Judgment determines the pattern of profit and loss for each segment of issued policies, subject of course to marketplace constraints. If one reflects long on these variables, it is not hard to reach the conclusion that it would be quite unlikely that the net cost of two different policy series would coincide for any given policy form over any given span of durations.

To further explore these matters, the committee pursued some of the significant differences that were found in computing cost indexes involving illustrative versus payable dividends. It might be helpful to follow just one analysis taken from the prospective cost indexes for a 5-year renewable-convertible term policy, as shown in Exhibit A2.

Looking at Policy 2 in Exhibit A2, we see an index of 25.61 at durations of 16-20 for a policy issued in 1977, based on illustrative dividends under the current dividend scale, while the index is 28.64 for a policy issued in 1962 and now entering durations 16-20. The difference of 3.03 in favor of the 1977 issue would seem to reflect a significant cost reduction.

It should be emphasized that the 1962 and 1977 issues are truly comparable policies. They are priced by consistent philosophies; they provide the same benefits, including essentially the same renewal and conversion provisions; and, since short-duration renewable term insurance is involved, there are no guaranteed cash values to confuse the picture. However, there is this significant difference: the 1962 policy was offered at a minimum insurance amount of $5,000, and the average sized policy sold was about $14,000; whereas the 1977 policy is offered for a minimum of $10,000 and the average sized sale is over $28,000.

The analysis showed that this doubling of the minimum and average size was the reason, both directly and indirectly, for the difference in prospective cost indexes. The direct effect came from expenses which are charged on the basis of each $1,000 of the policy size – i.e. the same dollar amount of expenses, when translated to a per $1,000 basis, is twice as much for a policy average size of $14,000 as for one of $28,000. As an indirect effect, the pricing of the 1977 policy took account of the more favorable mortality which is associated with policies of larger average size.

This analysis is of particular importance today, in a period after many years of progressive inflationary pressures. It points to the general axiom that, although the use of current experience factors in both illustrative and payable dividend scales can provide a base for consistency between new issues and existing business, it cannot eliminate past experience (such as the average size of a policy class) which continues to affect current costs.

The same thread of changed experience ran through most of the analyses. Other reasons were discovered and, in all cases, it was possible to arrive at a satisfactory rationalization of differences in cost indexes. It became evident that any statistical comparison between indexes involving paid dividends versus those involving illustrative dividends would have to allow wide discrepancies if it were to accommodate all legitimate differences, and it is highly probable that some not-so-legitimate difference could fall within the same statistical bounds.

A corollary to these conclusions may also be inferred. Company managements are charged now with making the multitudinous judgments involved in a cost structure, and they make them in widely varied ways which give the life insurance business the diversity and responsiveness to change it has. If rigid, statistically measured requirements are introduced into the process, it would necessarily substitute regulation for treasured management judgment and discretion.

Probable Future Course of Committee Work

A mathematical approach to controlling activities that may need control is sufficiently appealing that, if it is found impracticable, we may tend to believe that nothing is possible. The committee has not reached that level of despair. Rather, it believes that what has been demonstrated is that dividend practices require the exercise of skilled professional judgment, the results of which are neither unique nor amenable to rigid prescription.

Those judgments clearly lie in the domain of the actuary. It is a natural conclusion that actuarial organizations have a duty to recognize and strengthen the basis on which individual actuaries perform those tasks through the formulation of appropriate guides and opinions relating to conduct in this area.

Committee members recognize a close parallel between this dividend philosophy question and the questions which led to guides and opinions in the pension fund valuation field.

Such action by the actuarial bodies would not be wholly unrelated to questions of regulation. Probably some related actions would be appropriate there:

1. Those states which do not have adequate statutes or regulations relating to dividend illustrations could improve what they have. A model regulation or statute might be in order.

2. Schedule M could be improved.

3. An actuarial certificate might be devised to confirm use of proper methods of handling dividend matters.

A number of efforts toward formulations of guides and opinions have been made by committee members during this past year. The directions have been quite disparate. There is not sufficient agreement as yet to have anything that could be considered even a tentative proposal. However, to aid consideration and discussion of the subject, two examples of these early efforts are included in a following Appendix B.

There are indications that any guides and opinions will have to approach the dividend illustration question partly via the processes of dividend apportionment. The committee is not wholly displeased with that prospect. It believes that it is important to keep much of the dividend apportionment process in the hands of company management. However, those rights should not be defended absolutely, for the public has to be assured that this very complex process is being conducted according to high standards. And there is sufficient critical comment, both from within and without the life insurance business, to believe there is some need to provide that assurance. It seems probable that many actuaries believe there are abuses that need correcting. At the same time, many actuaries have stoutly defended actions of specific companies which have been publicly criticized.

A number of issues involved in the overall dividend illustration question have been set aside temporarily by the committee in the belief that they could better be dealt with after the main line of attack had been developed. These include:

1. The use of investment generations in individual lines. At its first meeting the committee agreed that there is nothing inherently inequitable about such usage, but that obvious practical issues are provoked by it. (In order to provide a technical base for use when the committee considers this issue, the chairman and secretary jointly authored a paper on the subject which is being published by the Society.)

2. Canadian aspects of the question. The regulatory framework is significantly different in Canada, as is life insurance practice. Some modifications may be necessary in any program devised with U.S. conditions in mind.

3. A variety of issues that derive from the relationship between dividends paid to a class of policies and the earnings attributed to that class. These include such fairly trivial questions as the frequency with which paid dividends should change to reflect changing experience, on the one hand. On the other, fundamental questions such as the degree of discretion that management should have in determining how much surplus to distribute or retain. Many of these issues can be addressed by guides or opinions.

   At one extreme, there are some questions which relate to policies on which the dividends paid clearly bear no relationship to earnings, and the state statutes and regulations under which the companies operate impose no restrictions in this respect. The basic issue here seems to be whether such payments are properly described as "dividends," whether companies should be allowed to conduct "participating" insurance in such fashion. This is an old controversy, and one with its own unique issues.

Appendix A: Cause for Appointment

The computation of dividends has always been a major responsibility of the actuary. Its execution has varied aspects, ranging from the management of office systems for the distribution of dividends to the resolution of philosophical questions underlying the dividend scales. In recent years, events have focused a great deal of attention on the way in which these tasks are carried out – attention which ultimately led to the creation of the Society's Committee on Dividend Philosophy. There follows a review of much of this recent history.

Illustrated Dividends in Cost Comparisons

It did not take long before those examining the matter of life insurance cost comparisons and disclosure, an examination traceable to a 1968 speech of the late Senator Hart, brought the subject of dividends squarely into the discussion.

The Joint Special Committee on Life Insurance Costs was an industry committee appointed to review and make recommendations on the subject of life insurance cost comparisons. In its May 4, 1970 report that committee stated there had been five major criticisms leveled at the traditional method of comparing life insurance costs. Two of those major criticisms dealt with dividends:

(1) It (i.e. Traditional Net Cost) assumes the current dividend scale will continue unchanged, a clearly artificial assumption and certainly not an expectation. Nobody knows what dividends will be paid on participating policies in years ahead. Illustrative dividends do not represent estimates of what a company will pay. They are nothing more than just the company's current dividend scale as it would apply to a currently issued policy.

(2) It (i.e. Traditional Net Cost) assumes that all future changes in dividend scales will affect all companies in roughly the same manner or degree. Again, this is most unlikely to be the case since it disregards changing patterns within companies as to investment yields, underwriting results and expenses of operation.[1]

That same report went further and offered an opinion (based on some tests) about the usefulness of cost comparisons and the implications of including illustrated dividends:

> Our committee's belief is that the correlation of actual company cost rankings with the rankings determined by current scale dividends at the beginning of the period is good enough to make comparisons worthwhile, but not good enough to justify elaborate comparison processes. Furthermore, it is judged inadvisable to use periods of comparison that exceed twenty years[2]

In a 1974 report on how to compare life insurance costs, the Canadian Life Insurance Association included the following among a list of "limitations of all indices" in their 24 page report.

1. The indices assume a company's current scale of dividends will continue. In fact, a company's current dividend scale is based on its current earnings and is not a guarantee or even an estimate of what will be paid in the future. That will depend on the company's future earnings.[3]

From these and numerous other sources, it seemed cost comparisons justifiably would continue to include dividends, but that a lack of comparability of illustrated dividends would make cost comparisons less valuable.

<u>What is an Illustrated Dividend?</u>

For dividends actually <u>payable</u>, something like the following is widely accepted as a proper definition:

> A return of part of the premium on participating insurance to reflect the difference between the premium charged and the actual mortality, expenses and investment experience.[4]

Unfortunately, for <u>illustrated</u> dividends no such widely recognized definition exists. The trade and general press, insurance regulators and even government agencies have offered their own definitions, and they often were wide of the mark.

From an official publication of a state insurance department, we have this definition based on "predictions," with even a "projection" or two thrown in:

> Although the cost figures (for participating policies) assume dividends will be paid as predicated by the insurance company, it must be stressed that dividends are not guaranteed. They may or may not be paid in accordance with the current predictions of each company. Over the last twenty years, dividends of participating companies have generally equaled the predicted dividends. But there are companies which have fallen short of their dividend projections.
>
> We suggest you ask your insurance agent to show you how well the company has done in paying dividends on the type of policy you are considering, in accordance with its predictions over the last twenty years. These predictions of future dividend payments are usually referred to as "dividend projections."[5]

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1. Report of the Joint Special Committee on Life Insurance Costs, May 4, 1970, p. 6.

2. <u>Ibid</u> at 8.

3. <u>How to Compare</u>, Canadian Life Insurance Association, p. 18.

4. <u>Ibid</u> at 20.

5. <u>A Shopper's Guide to Life Insurance</u>, Pennsylvania Insurance Department, June 1972, p. 6.

The general press, in the following quote, describes a procedure for determining illustrated dividends that no responsible actuary would condone:

> The agent tots (sic) up an estimate of the annual dividends that you'll get over the 20-year period -- based on those paid in the past on similar policies.[6]

Another publication, whose basic mission is consumer advice, leaves the impression that companies are capricious, while at the same time it casts some question on the actions of the agent:

> This report is about dividends, the hidden part of the price structure. It's hidden because a dividend is whatever the company decides to pay, not what the insurance agent may have led you to believe when you bought the policy.[7]

Unacceptable definitions appear from surprising quarters. Consider this characterization of illustrated dividends which refers to those required to be disclosed in the sale of individual retirement annuities:

> (The disclosure document must include) a statement that the amount described in paragraph (d)(4)(v)(b)(1) of this section is a projection and is not guaranteed and a statement of the earnings rate and terms on the basis of which the projection is made;[8]

There have been attempts by the insurance industry to offer a definition or description of what an illustrated dividend is and what it is not. One of the more notable is this:

> 4. The use of illustrated dividends in preparing cost indexes should be clearly indicated and the nature of dividend illustrations should be clearly and accurately described . . . In this connection, it should be clearly stated that current dividend scales are not projections or estimates of the future. Furthermore, the use of projections or estimates of future dividends should be prohibited; and illustrated dividends should be required to be based on the current dividend scale in actual use by the insurer. It should also be made clear that dividend scales are not guaranteed and are quite likely either to increase or decrease.[9]

The above phrase that ". . . .illustrated dividends should be required to be based on the current dividend scale in actual use by the insurer. . . ." has broad general support – but there has been no general agreement as to what it means and how its application can or should be demonstrated.

Does the Public Understand Dividends Are Not Guaranteed?

Actuaries doubt there is adequate public awareness that illustrated dividends are not guaranteed. This was observed in the Society of Actuaries 1974 Report, when 53 out of 111 actuaries responded "no" to the question:

> Do you believe the public is sufficiently aware of the nonguaranteed nature of dividends?[10]
>
> Among the mutual company actuaries responding directly to the question, 71% believed the public was sufficiently aware of the nonguaranteed nature of dividends. On the other hand, only 28% of all the stock company actuaries so indicated.

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6. Medical Economics, October 28, 1975, p. 191.

7. Consumer Reports, November 1976, p. 659.

8. IRS Regulation 1.4C8-1, (d)(4)(4)(B)(2).

9. American Life Insurance Research Report to National Association of Insurance Commissioners, October 9, 1974, p. 5.

10. Philosophies in the Computation and Dissemination of Dividend Illustrations, September 1974, prepared by the Society of Actuaries Committee on Cost Comparison Methods and Related Issues (Special), p. 14.

> The most frequently mentioned reason for the belief in public awareness was the existence of caveats (23 responses). Actuaries of ten companies indicated as their reason the fact that few complaints had been received, although several conceded that this might possibly be only because paid dividends in recent years have usually exceeded those illustrated.[11]

Recent experiences, wherein illustrated dividends have been generally exceeded by those actually paid, could give illustrations an aura of being a "floor."

Manipulating, Tinkering, Rigging and Gimmicks

Some charge actuaries and insurance companies with tinkering. Money Magazine, in a 1976 issue, headlined an article, "Back in the Dark About Life Insurance Costs." The subhead read: Some insurers are tinkering with dividends to make their policies look cheaper."[12]

Others refer to the practice as "manipulating" and give examples of results it produces:

> That is, of course, a rather simplified sketch of an extremely complex dividend calculation – and a calculation subject to secret manipulation. The manipulation, critics contend, can and does result in:
>
> 1. Unilateral changes in the pmplicit terms of the original agreement, changes made many years after the sale.
>
> 2. Inequity between dividends paid long-time policyholders and dividends paid more recent policyholders.
>
> 3. Unreliable dividend illustrations in the sales pitches of insurance agents.[13]

That same source refers to it also as "rigging" and a quest for "gimmicks."

> Another problem with dividend illustrations is that some are being rigged to look good on cost comparison indexes. Increasing consciousness of price differences by life insurance buyers, stimulated by the publiction of price surveys (such as CU's in 1974), has caused some companies to look for gimmicks, such as increasing the dividend scale during the first 20 years and decreasing it afterward.[14]

One of the most relentless critics of life insurance company dividend practices has been Professor Joseph M. Belth. His monthly newspaper, The Insurance Forum, has published dozens of articles alleging inequitable treatment of old policyholders for the benefit of new purchasers. While such charges seem increasingly popular in recent years, their frequency does not make them correct. There is evidence the majority of actuaries feel there are sound, consistent philosophical principles upon which dividends -- illustrated or paid – are based.

> The foregoing material indicateds that most of the actuaries responding to the questionnaire believe that the method of surplus distribution used in their companies is founded on firm philosophical principles, and that only a few actuaries were dissatsfied with their companies' or clients' philosophy.[15]

Feelings, both pro and con, seem not to be the place where this charge should be left. A better articulation of the current state of the art, and guidelines if needed, seem to be desirable.

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11. Ibid at 15.

12. Money Magazine, July 1976, p. 69.

13. Consumer Reports, November 1976, p. 659-60.

14. Ibid at 662.

15. Philosophies in the Computation and Dissemination of Dividend Illustrations, September 1974, prepared by the Society of Actuaries Committee on Cost Comparison Methods and Related Issues (Special), p. 30.

Do All Use Current Experience?

Beyond a question of a consistent and sound philosophy within a single company,there is the comparability between two or more companies and their products. A 1974 industry report indicated the basis of illustrated dividends was not uniform between companies:

> Dividend illustrations made at the time of sale are commonly based on a company's current dividend scale, although this practice is not universally required by law or regulation and is not universally followed by all companies.[16]

This lack of universality was supported by the Society of Actuaries report:

> The dividend scales of 41 of the 88 companies currently writing participating business (47%) are based on current experience, generally unaltered for possible or probable future changes; the scales of 43 companies (49%) are based on different assumptions. The remaining four companies did not respond to the question.
>
> Several of the 41 companies using current experience indicated that they would consider a change in their practice if it seemed likely that current experience would deteriorate, as indicated below:
>
> > "[We would] definitely use current experience in a period of improving factors. If faced with substantial adverse trends, we would probably make some adjustments."
>
> Among the 43 companies not using current experience, there were some which used expected future experience, and others which used expected future experience less a safety margin.[17]

Even for those who use "current experience," what does that term mean? Of particular significance in recent years is the matter of interest allocations to ordinary life insurance dividends. This has been the most visible controversy. Many articles have been written chastising those companies who would use the investment year method (or so-called "new money") on their current dividend illustrations. Others have pointed out the noncomparability of two dividend illustrations, one based on "new money" and the other on the company's total investment portfolio rate. Certainly other assumptions (regarding, for example, mortality or expenses), though drawing less clamor, are also subject to the same question: Just what is meant by "current experience," precisely? The answer to this question and, particularly, the matter of comparability was on many actuarial minds in late 1975.

Some Advice and Suggested Reforms

Though they don't sound optimistic about early progress, some outside observers acknowledge there are committees formed to look at this subject. (This quote relates especially to different investment income treatment between companies.)

> In what's likely to be a glacial process, no fewer than three committees have been formed by the insurance industry and its regulators to ponder the new dividend formula. If reliability is to be restored to cost comparisons, all companies should be required to use the same formula. Preferably, it should be the old one. After all, the promise of sharing in the company's good investment fortunes was one reason old customers bought dividend-paying policies in the first place.[18]

Another source advises readers to: (1) avoid companies which use the investment year method; (2) ask the agent for illustrations of dividends for 30 to 40 years, not just 20; and (3) if one is an "old" policyholder, one should write the company and ask how the dividend is calculated. If that inquiry is unsatisfactorily handled, one should write the state insurance department, for "that will add to the pressure for reform."[19]

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16. American Life Insurance Association Research Report to National Association of Insurance Commissioners, October 9, 1974, p. 1.

17. Philosophies in the Computation and Dissemination of Dividend Illustrations, September 1974, prepared by the Society of Actuaries Committee on Cost Comparison Methods and Related Issues (Special), p. 31-32.

18. Money Magazine, July 1976, p. 70.

19. Consumer Reports, November 1976, p. 662.

That source goes on:

Here are the reforms most needed:

1. Where state insurance departments lack regulatory authority over dividends, they should seek it from state legislatures.

2. The unilateral adjustment of dividend formulas after the time of sale should be permitted only after careful regulatory review, including public hearings.

3. Regulators should consider a ban on the investment-year method and, in the meantime, should require any company using it to disclose the fact to its policyholders.

4. Insurance deparments should require companies to make reasonable disclosure to policyholders who want to know how their dividends are calculated.

5. In sales illustrations, fattened dividends paid to recent policyholders should not be projected into the distant future. If a company is paying enlarged dividends to people who bought their policies within, say, the past five years, the company should be permitted to project those dividends only four years into the future.

6. Regulators should examine dividend scales for discontinuities that appear designed to take artificial advantage of the structure of cost indexes. Such dividend scales should be discouraged through publicity and through regulation.[20]

NAIC's 1975 Report and Subsequent Statements

The NAIC Life Insurance Cost Comparison (C3) Task Force, when assigning research projects in June of 1973, recognized that dividend illustrations play a key role in the cost comparison subject.

While such research was being pursued, one of the members of that NAIC task force expressed thses views about illustrated dividends at a Society of Actuaries Concurrent Session on "Insurance Company Regulation Resulting From Consumerism" in New York on April 17, 1975:

> My final observation deals with dividend illustrations. Most of us who have worked for large mutual insurance companies have witnessed the emphasis, real or imagined, on contriving dividend scales so as to optimize the company's competitive position in cost comparisons. With the inevitable increased importance attached to cost disclosures and cost comparisons, this situation of "tail wagging the dog" can only get worse, and the people most likely to suffer are those old policyholders in closed blocks of business whose dividends are no longer illustrated.
>
> I suspect the time has come for a critical reevaluation of the traditional regulatory position (and company disclaimer) that dividends are not estimates or predictions of amounts the company will actually pay. What is wrong with a company's "predicting" what its future dividends will be? The usual concern is that freeing dividend illustrations from the reality of dividends currently paid will lead to uncontrolled competition among optimists or liars. I see no theoretical reason why "predicted" dividends could not be soundly implemented, or even required for cost comparison purposes, given an enlightened and effective system of governmental regulations to back up the predictions. As a first step, interest, mortality and expense assumptions would have to be either standardized or justified as consistent with logical projections of current conditions. More important, companies would be held accountable by regulators for a reconciliation of actual dividends to projected dividends, with the understanding that dividend predictions would not be permitted by any company that was unable to satisfy the reconciliation.[21]

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20. Ibid.

21. Society of Actuaries Record, Vol. 1 No. 2, p. 225 ff., William W. White, Actuary, New Jersey Insurance Department.

At about the same time, the Actuary of the Tennessee Insurance Department suggested to the NAIC task force that dividend illustrations be limited to the first 20 years of a policy.[22] (This proposal was subsequently dropped and dividends should be permitted to be illustrated beyond 20 years ". . . so long as the proper qualifications and definitions are stated."[23])

In the NAIC task force's report of December 9, 1975, they identified eleven items worthy of further study.

> In the process of developing the proposed model solicitation regulation, the task force had identified a number of additional matters which it believes are in need of further study. With the approval of the Life Insurance (C3) Subcommittee, the task force will proceed in the following areas:
>
> 1. . . .
>
> 2. A study of methods of detecting manipulation of policy values and dividends in such a way as to produce unrealistically attractive cost indexes.
>
> 3. Development of appropriate regulation of dividend illustrations.[24]

Daniel J. Andersen, then Chief Actuary of the Iowa Insurance Department, which department chaired that task force in 1976, indicated at the Scoiety of Actuaries May 20, 1976 meeting in Houston:

> First on our list of priorities is the development of a regulation for the control of life insurance dividend practices. This will include control of dividend illustrations as well as maintenance of equity in the distribution of surplus . . .
>
> The NAIC task force plans to meet with the Society Committee on Dividend Philosophy in the near future in order to reach mutual agreement as to the nature of the study which that committee will be undertaking as well as the extent to which the NAIC can rely on the Society of Actuaries to provide the necessary basis on which to construct a regulatory framework.[25]

These statements indicate the NAIC's interest in this subject.

Veterans Affairs and Senator Stone

In late 1975, the U.S. Senate Subcommittee on Housing and Insurance of the Committee on Veterans Affairs held hearings to consider Senate Bill S. 2218, sponsored by Senator Richard Stone of Florida. The bill's preamble identified it as a bill "to require administration of veterans' affairs to provide veterans with certain cost information relating to the conversion of government supervised insurance to individual life insurance policies."

In an October 16, 1975 letter requesting individuals and groups to testify at the hearings, Senator Stone included this request:

> Some observers have suggested that an adequate system of disclosure at the point of conversion include information going well beyond the conventional twenty policy years. Please include in your statement your thoughts on this question.

Mr. Ernest J. Moorhead, in his written response to Senator Stone, stated:

> I regard furnishing information, other than policy dividends, beyond the twentieth policy year as unobjectionable but of minor importance. I oppose illustrating policy dividends beyond the twentieth policy year, on the ground that such information conveys an unjustified inference of durability of whatever dividend scale happens to be in effect when the policy is purchased.[26]

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22. July 21, 1975 letter from C.F.B. Richardson to S.C. DuRose, Chairman, NAIC Life Insurance Cost Comparison Task Force.

23. September 25, 1975 letter of Mr. Richardson.

24. NAIC Life Insurance Cost Comparison (C3) Task Force Report, December 9, 1975.

25. Society of Actuaries Record, Vol. 2 No. 2, p. 368-9.

26. Hearings Before the Subcommittee on Housing and Insurance of the Committee on Veterans' Affairs on S.2218, p. 507.

Mr. Moorhead, in his oral testimony, also urged some action by the actuarial profession on various aspects of life insurance dividends:

> I think it should also be asked where the actuarial profession stands in offering solutions to some of the puzzling questions that arise when one speaks of helping people to make rational and prudent choices.
>
> Actuarial expertise, judgment and even standards of conduct become issues in several respects which I will attempt to itemize. First there is the question of so-called actuarial manipulation . . . .
>
> Second, . . . there are questions about the reliability of dividend illustrations . . . .
>
> The third of the matters that belong in the actuarial field is the question . . . whether the public can safely rely on that word 'participating' as meaning what the buyer's guide says that it means, and what the insurance policy says that it means . . . .
>
> I suggest that we ask the governing bodies of the Society of Actuaries and the American Academy of Actuaries whether the actuarial profession has said all that it thinks appropriate about (these) matters . . . .[27]

Mr. John M. Bragg, then President of the Society of Actuaries, wrote as follows to Senator Stone:

> Following the hearings regarding the S. 2218, Mr. E.J. Moorhead relayed me certain additional questions which had arisen and your inquiry as to whether the actuarial profession had any further comments to make.
>
> In particular, Mr. Moorhead mentioned the matter of the reliability of dividend illustrations. In September, 1974, a committee of the Society of Actuaries published a study of the dividend practices of a representative group of life insurance companies. Following up this study, the Society has just created a new committee to inquire into dividend philosophies on an in-depth basis. We hope that the results will be very beneficial for the life insurance industry.[28]

<u>What About Canada?</u>

Nearly all of the sources quoted above relate to the U.S. scene. But the Canadian side of the border has its own stirrings on this subject. One actuary summarized the situation there in these words:

> The impact of consumerism in Canada is parhaps a year or two behind that in the United States, but is making itself felt. The consensus among senior actuaries and some of the superintendents is that self-regulation is much to be preferred over statutory regulation. It is acknowledged that changes are necessary if they are not made voluntary within the industry some form of regulation will be imposed.[29]

<u>Appendix B: Illustrations of "Opinions" Re Dividend Practice</u>

There are set out here two trial drafts of an Opinion relating to dividend practice. These are both virtually first attempts. They have not had the benefit of adequate review and discussion and cannot be considered as recommendations of either the Committee on Dividend Philosophy or the individual members of that committee who produced the drafts.

They are set out here as illustrations in the hope that they may help focus the discussions by the membership at the October meeting of the Society.

Throughout the two drafts, as in those Opinions which have been adopted by the Society in the past, references to the "Committee" refer to the Committee on Guides to Professional Conduct. Obviously, those references, in the present draft form, do not imply approval by, or even exposure to, the Committee on Guides to Professional Conduct.

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27. <u>Ibid</u> at 501 ff.

28. Bragg letter of December 24, 1975, to Senator Stone.

29. October 4, 1976 memorandum from Robin Leckie.

Draft 1

Opinion S-"N": Actuarial Principles and Practices in Connection Wtih Dividend Apportionment and Illustration

Introduction

This Opinion is intended to interpret and amplify the applications of sections 1, 2, 3 and 4 of the Guides to Professional Conduct and their relation to the apportionment and illustration of dividends for individual life insurance, disability and annuity contracts.

As such, the Opinion is directed to actuaries who prepare actuarial reports providing information to consumers and regulators on the nature and character of dividends paid and illustrated. The Opinion is primarily concerned with disclosure of the basis of dividend apportionment and illustration.

The insurance industry has a tradition of concern for equity among classes of contractholders and a long-standing practice of regulatory overview. The Committee recognizes a high degree of public interest. Insurance buyers need to understand the nature of participating contracts and to make cost and value comparisons. Actuaries are increasingly called upon to disclose methods of dividend apportionment and the bases of illustrative dividends in connection with the sale of insurance.

The Committee recognizes the prevalence of the use of the "contribution plan" for dividend allocation in Canada and the United States. The principle was succinctly described by MacLean and Marshall in Distribution of Surplus, page 24: "The contribution plan, which is the method of surplus distribution usually employed in the United States and Canada, is based on the principle of returning to each policyholder that part of divisible surplus which may be considered has having been contributed by him" This principle has obvious appeal in terms of equity. Yet there is no one approach or actuarial methodology which uniquely or exclusively embodies the contribution principle. The Committee believes that there would be merit in development of further interpretation of principles underlying dividend apportionment.

In the early years of participating insurance, dividend illustrations for participating contracts were on the basis of actual dividend histories. This had the advantage of reflecting the company's actual performance. The difficulty was that dividend histories related to a past period of performance and to experience under contracts no longer issued. The Committee recognizes a concept which has been widely followed for more than 50 years: the illustration of dividends on the basis of current operating experience which is generally reconcilable to that used in the apportionment of dividends under contracts currently in force. The Committee believes that there would be merit in the development of further interpretation of the meaning of "current experience" in connection with the communication on the basis of dividend illustrations.

The Applicable Guides

Much of the material appearing in the Guides to Professional Conduct under paragraph 4, Calculation and Recommendations, is applicable to the disclosure of the method and bases of dividend apportionment and illustration.

For example, Guide 4(a) indicates that a member will include in any report or certificate quoting actuarial costs, reserves or liabilities, a statement or reference describing or clearly identifying the data and the actuarial methods and assumptions employed. While "dividends" are not mentioned, given a public need, the extension of this Guide to dividends is obvious.

Guide 4(b) indicates that a member will exercise best judgment to ensure that calculations and recommendations are based on sufficient and reliable data, that assumptions are adequate and appropriate and that the methods employed are consistent with sound principles established by precedence or common usage within the profession.

Guide 4(c) states that a report which deviates from this practice will include an appropriate and explicit qualification of the actuary's findings.

The latter two Guides directly apply to statements about dividend apportionment and illustrations, and Guide 4(a) readily applies by extension.

Clarifying Statement of Working Guide

This Opinion deals primarily with the descriptive qualities of statements about dividend apportionment and the basis of dividend illustrations.

This Opinion does not concern itself with the determination of the amount of earnings of an insurance company to be allocated as dividends. The determination of divisible surplus is clearly a matter to be decided by the management of the insurance company. Those determinations can only be made with regard to a company's actual operating experience, its trends, safety margins in premiums and the degree of financial solidity desired.

This Opinion does not attempt a precise definition of "equity." The appeal of the contribution principle in terms of equity is obvious. Many individuals have espoused it. Many companies have practiced it. It may be implicit in regulation of the past and present. Equity, however, in the operative sense is a matter either of law, or more broadly, of the social consensus which underlies statute or case law. The Committee encourages individual actuaries to espouse their views in regard to equity and to pursue them vigorously. The Committee recognizes, however, that neither an individual nor a professional body may interpret the meaning of equity in a binding fashion. Equity is a social concept and its interpretation lies in the judicial or legislative process.

In regard to dividend apportionment, the Committee endorses the contribution principle, as described above, and recognizes that this principle is embodied in the commonly used "three-factor formula." The Committee recognizes, however, that the three-factor formula is not the sole and exclusive formula by which the principle may be applied. Further, in regard to the experience factors used in any formula, the Committee recognizes that it is inappropriate to prescribe inflexible guidelines, but that the selection of factors involves professional judgment based on the circumstances applicable to a particular situation.

In regard to illustrative dividends, the Committee endorses the practice, widely followed, of illustrating dividends based on current experience, where the factors used in the dividend formula are generally reconcilable to those currently being used to calculate dividends now being paid. But again the Committee recognizes that it is inappropriate to prescribe inflexible guidelines for the definition of "current experience," and that the selection of assumption and methods involves again professional judgment based on the circumstances applicable to a particular situation.

Within these constraints, the Committee has set forth Opinions which follow and encourages the continuing promulgation of recommendations and interpretations by an appropriate committee of the Society.

Opinions

1. The contribution principle of dividend apportionment distributes divisible surplus among policyowners in proportion to their contribution to that divisible surplus. This is commonly carried out through dividend classes, composed of a group of policies with sufficiently homogeneous cost characteristics so that each unit of insurance in the group may, as a practical matter, be considered as having contributed equally to divisible surplus. Because of the prevalence of this method, the Committee believes that communication of a method of dividend apportionment based on a different principle should indicate that fact by means of a general description of the different principle.

2. In applying the contribution principle to determine dividends for a given class, (a) the contractual factors in the formula should be those of the class, and (b) the experience factors in the formula should reflect actual experience of the class as close as practically possible. When statistically credible data is not available, experience factors may be based on larger, though less homogeneous, classes or similar classes, as appropriate on the basis of actuarial judgment. An experience factor should be identical for all classes which are homogeneous, and differences between classes should be based on measurable differences in experience. Any significant variation from these principles should be noted in a description of a dividend apportionment process.

3. Illustrative dividends should reflect actual dividend apportionment to the greatest extent possible. If illustrative dividends are based on some principle other than that used for current apportionment, this fact should be disclosed. The judgmental process, incident to dividend apportionment where there is no appropriate statistically credible data, also applies in the determination of current experience factors for illustrative dividends. If illustrative dividends are based on experience factors that are not reasonably related to the actual experience of the class, this fact should be disclosed.

4. Current experience, in the presence of secular trends, may include projection through the next ensuing one-year dividend scale period. Any further projection on a basis that produces larger dividends should be disclosed. If, in the actuary's opinion, secular trends beyond that period would lead to experience factors which are less favorable than those currently experienced and used for illustrative dividends, this opinion should be disclosed.

Draft 2

Opinion 7: Actuarial Principles and Practices in Connection With Dividend Calculation and Illustration

Introduction

This Opinion is intended to interpret and amplify the application of the Guides to Professional Conduct to the apportionment of surplus and to the illustration of dividends for individual participating insurance. The Committee recognizes that it would be inappropriate to prescribe inflexible guides for the performance of the actuary's work in connection with dividends. They also recognize the high degree of professional judgment necessary due to the number and complexity of various dividend components and the diverse nature and circumstances of the various insurers which the actuary may serve. The promulgation of uniform procedures or practices which fail to take account of such variables would in the opinion of the Committee be unprofessional.

On the other hand, the Committee believes that the effectiveness of the actuary would be enhanced by the adoption of a statement of principles relating to generally accepted application of actuarial science to dividend problems and to adequate disclosure of pertinent and material facts bearing on the interpretation of his work. It is believed that such a statement of the basic responsibilities of the actuary will tend to minimize possibilities of misunderstanding or misinterpretation by those relying on this work.

Clarifying Statement of Working Guide

A requirement common to all actuarial procedures is that assumptions and methods be selected and applied with integrity, informed judgment and perspective in relation to the purpose for which the results are intended.

In particular, item 4(b) of the Guides is relevant:

> 4(b) The member will exercise his best judgment to ensure that any calculations or recommendations made by him or under his direction are based on sufficient and reliable data, that any assumptions made are adequate and appropriate, and that the methods employed are consistent with the sound principles established by precedents or common usage within the profession.

Opinions

1. The determination of the total amount available for dividends is a decision to be made by company management with the assistance of the actuary in light of many factors paramount among which are the solvency of the company and its ability to fulfill all contractual guarantees. Additional factors include regulatory requirements, the size and nature of reserves, the size of unassigned surplus, the level of risks undertaken by the company, financial practices and the overall interest of policyowners, and stockholders if any.

2. A basic principle of surplus apportionment is to distribute the divisible surplus among policyowners in the same proportion as the policyowners are considered to have contributed to that divisible surplus. Any method following this principle is said to be a Contribution Method. Thus, a Contribution Method must provide a reasonable recognition of earnings and the sources from which they have arisen in this broad sense is understood to provide the essential equity implied by participating insurance.

3. Therefore, in the application of a Contribution Method to determine dividends, it is necessary, either explicitly or implicitly, to employ parameters through which are recognized earnings arising from various sources. These parameters when interpreted in relation to a specific source of earnings are considered to be experience factors.

4. A group of policies for which the same value of a particular experience factor is used in determining dividends constitutes a dividend class with respect to such factor. When there is more than one dividend class with respect to a particular experience factor, differences in the value of such experience factor between any two classes should be based on demonstrable differences in actual experience as between those two classes.

5. As used in this opinion, actual experience of a dividend class means such experience literally to the extent that it is determinable, available and statistically credible. When lacking such suitable data, actual experience is to be interpreted with sound professional judgment based on experience of other similar but not identical classes of business either in the same company or other companies or from other sources.

6. The Committee further believes that the dividends illustrated for new sales should be calculated in a manner consistent with the calculation of dividends actually being paid. Thus, such illustrated dividends should be based on current experience factors whenever new business is of the same class as existing business for which dividends are currently being paid. If new business represents a different class, illustrations thereof may be based on different experience factors – but only to the extent that the difference in those factors represents adjustments to current experience based on demonstrable differences between classes. In the sense that such illustrated dividends are so computed, they represent dividends based on current experience as required by law and tradition.

7. It is the opinion of the Committee that the actuary take into consideration the published Recommendations of the Committee on Dividend Philosophy. An actuary who uses principles or practices which deviate materially from such recommendations must be prepared to support his particular use of such principles and practices and should include in any report or statement he prepares appropriate and explicit information to fully disclose the nature and impact on dividend illustrations of such deviation. It is intended that such recommendations, together with this Opinion, constitute what shall be known as Generally Accepted Actuarial Principles and Practices Relating to Dividends.

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American Council on Life Insurance

Draft Proposed NAIC Model Annuity and Deposit Fund Disclosure Regulation

Section 1. Authority.

This rule is adopted and promulgated by (title of supervisory authority) pursuant to sections [4(1)(a) of the Unfair and Deceptive Acts and Practices in the Business of Insurance Act] of the insurance code.

Section 2. Purpose.

A. The purpose of this regulation is to require insurers to deliver to prospects for annuity contracts or for deposit funds marketed in conjunction with life insurance policies or annuity contracts, information which helps the prospect select a plan appropriate to his needs, improves his understanding of the basic features of the plan under consideration and improves his ability to evaluate the relative benefits of similar plans.

B. This regulation does not prohibit the use of additional material which is not in violation of this regulation or any other (state) statute or regulation.

Section 3. Scope.

A. To the extent hereafter provided, this regulation shall apply to any solicitation, negotiation or procurement of annuity contracts or of deposit funds marketed in conjunction with life insurance policies or annuity contracts occurring within this state. This regulation shall apply to any issuer of life insurance policies or annuity contracts including fraternal benefit societies.

B. This regulation shall apply solely to:

   1. Individual deferred annuities other than variable annuities and investment annuities; and

   2. Deposit funds which may be used to purchase individual annuities.

C. This regulation shall not apply to:

   1. Group annuity contracts;

   2. Individual immediate annuity contracts; and

3. Contracts issued in connection with employee benefit plans as defined by section 3(3) of the federal Employee Retirement Income Security Act of 1974 as now or hereinafter amended (ERISA).

Section 4. Contract Summary.

A. For the purposes of this regulation, Contract Summary means a written statement describing the elements of the contract, including but not limited to:

1. A prominently placed title as follows: "Statement of Benefit Information."

2. The name and address of the insurance agent or, if no agent is involved, a statement of the procedure to be followed in order to receive responses to inquiries regarding the Contract Summary.

3. The full name and home office or administrative office address of the company which will issue the annuity contract or administer the deposit fund.

4. The form of annuity and of the death benefits during the deferred period.

5. A prominent statement that the contract does not provide cash values if such is the case. For purposes of this regulation, cash value means the amount payable in cash upon surrender and does not mean the amount available to purchase annuities if the latter amount differs from the former.

6. Guaranteed annuity payments at the scheduled commencement of the annuity provided that all scheduled considerations are paid.

7. Corresponding illustrative annuity payments based on (1) the current dividend scale and the interest rate currently used to accumulate dividends under such contracts or the current excess interest rate credited by the company and (2) current annuity purchase rates.*

8. For deferred annuity contracts or deposit funds for which guaranteed cash surrender values at any duration are less than the total considerations paid, a prominent statement that such contracts or funds may result in loss if kept for only a few years together with a reference to the schedule of guaranteed cash surrender values required by 9(c) of this section.

9. The following amounts, where applicable, for the first five contract years and representative contract years thereafter sufficient to clearly illustrate the patterns of considerations and benefits, including but not limited to, the tenth and twentieth contract years and at least one age from 60-65 or the scheduled commencement of annuity payments, whichever is earlier:

   (a) The gross annual or single consideration for the annuity contract.

   (b) Scheduled annual or single deposit for the deposit fund, if any.

   (c) Total guaranteed cash surrender values at the end of the year or, if no guaranteed cash surrender values are provided, total guaranteed paid-up annuity values at the end of each year. Values must be shown separately for the basic contract or policy from those shown for the deposit fund.

   (d) Total illustrative cash values or paid-up annuity benefits based on (1) the current dividend scale and the interest rate currently used to accumulate dividends under such contracts or the current excess interest rate credited by the company and (2) current annuity purchase rates.

10. A Contract Summary which includes values based on the current dividend scale or the current excess interest rate shall also include a statement that such values are illustrations and are not guaranteed.

11. The date on which the Contract Summary is prepared.

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*A dividend scale or excess interest rate which has been publicly declared by the company to be credited to new issues with an effective date not more than three months subsequent to the date of declaration shall be considered a current dividend scale or current excess interest rate.

B. The Contract summary must consist of a separate document. All information required to be disclosed must be set out in such a manner as not to minimize or render any portion thereof obscure. Any amounts which remain level for two or more contract years may be represented by a single number if it is clearly indicated what amounts are applicable for each contract year. Amounts in items 6, 7 and 9 of this section shall, in the case of flexible premium annuity contracts, be determined either according to an anticipated pattern of consideration payments or on the assumption that annual considerations payable will be $1,000. If more than one insured is covered under one contract or deposit fund, benefits shall be displayed separately for each insured or for each class of insureds if benefits do not differ within the class. Zero amounts shall be displayed as zero and shall not be displayed as blank spaces.

Section 5. Disclosure Requirements.

A. The insurer shall provide to all prospective purchasers a Contract Summary prior to accepting the applicant's initial consideration or deposit, unless the contract for which application is made contains an unconditional refund provision of at least ten days or unless the Contract Summary contains such an unconditional refund offer, in which event the Contract Summary must be delivered with the contract or prior to delivery of the contract.

B. The insurer shall provide a Contract Summary to any prosepctive purchaser upon request.

Section 6. General Rules.

A. Each insurer shall maintain at its home office or principal office, a complete file containing one copy of each document authorized by the insurer for use pursuant to this regulation. Such file shall contain one copy of each authorized form for a period of three years following the date of its last authorized use.

B. An agent shall inform the prospective purchaser, prior to commencing a sales presentation, that he is acting as a life insurance agent and inform the prospective purchaser of the full name of the insurance company which he is representing to the buyer. In sales situations in which an agent is not involved, the insurer shall identify its full name.

C. Terms such as financial planner, investment advisory, financial consultant or financial counseling shall not be used in such a way as to imply that the insurance agent is generally engaged in an advisory business in which compensation is unrelated to sales unless such is actually the case.

D. Any reference to dividends or to excess interest credits must include a statement that such dividends or credits are not guaranteed.

E. A presentation of benefits shall not display guaranteed and nonguaranteed benefits as a single sum unless guaranteed benefits are shown separately in close proximity thereto and with equal prominence.

F. Sales promotion literature and contract forms shall not create the impression that annuity contracts or deposit funds are the same as a savings account or deposit in a banking or savings institution and the use of passbooks which resemble savings bank passbooks is prohibited.

Section 7. Failure to Comply.

Failure of an insurer to provide or deliver a Contract Summary as provided in Section 5 shall constitute an omission which misrepresents the benefits, advantages, conditions or terms of an annuity contract or of an insurance policy.

Section 8. Effective Date.

This rule shall apply to all solicitations which commence on or after (insert a date at least six months following adoption by the regulatory authority).

The Life Agent's Compensation Task Force

Boston, Massachusetts
October 7, 1977

The Life Agent's Compensation Task Force met in Boston, Massachusetts on October 7, 1977. Present at the meeting were: Hon. Dick L. Rottman, Chairman, Nevada; Dr. Ramon Estefania, Chief Actuary, South Carolina (Dr. Estefania formerly was chairman of this task force); Robert R. Googins, Chairman, Industry Advisory Committee; Elizabeth Tovian, LIMRA; Ronald L. Doan, Equitable Life Assurance Society; members of the Industry Advisory Committee. Task force members not in attendance included Texas, Ohio and New York.

The first report of the industry advisory committee has been pubhished in 1976 Proceedings Vol. II, 558-585. This report studied the existing compensation on sales and product mix, income and expenses of life agents, agent's compensation systems as compared with other retailed structures, a review of advertising practices that may relate to agent's compensation as well as an examination of the so-called "specialty" products.

In their second report, the industry advisory committee related the information not available at the time they issued their first report since some surveyed data had not yet been received. Also, further research was being undertaken by the Life Insurance Marketing Association concerning agent's earnings and the impact of New York's Expense Limitation Statute might have on commission sales.

The task force accepted the industry advisory committee studies and congratulated them for a thorough job done objectively and factually.

The two reports were discussed at the Boston meeting. The reports were limited to the existing system including the expense limitation statutes .The task force had an additional charge as stated in the 1974 report to the Life Insurance (C3) Subcommittee, which was to study the "feasibility of adopting a model statute covering expense limitations."

The statistical studies, surveys, analysis and methodology of the industry advisory committee substituted facts for appearances and demonstrations for impressions. This is precisely what the task force wanted to produce when its members prepared the questions for the industry advisory committee. The original six questions posed by the task force attempted to cover the principal issues concernings agent's compensation that were of concern to the public in general and insurance regulators. These questions were thoroughly researched, as shown in the reports and at the Boston meeting. Little evidence was found to support any allegations that may have been implied by the six questions.

The task force concurs substantially with the industry advisory committee reports. The present agent's compenstaion system is sufficiently complex that the implications of tinkering with the system through a system of arbitrary controls appear to be of questionable consumer value. To impose a regulation at this time probably would be more a cosmetic rather than a real life insurance cost-cutting device.

The report of S. Travis Pritchett, Associate Professor of Finance and Insurance at the University of South Carolina, has concluded that agent's commissions are not a statistically significant determinent of policyholders' costs (at least in New York versus Non-New York context) and that New York's limitations on agent's compensations are insufficient -- in and of themselves -- to strongly influence the costs of life insurance to consumers.

The task force also discussed the possible effects of a gross premium regulation, since the limitation of agent's compensation deals with only one factor in the cost of life insurance. Because this is a tantamount to rate regulation, it was decided to reject the idea of a gross premium regulation. It appreas that there is sufficient competition in the sale of life insurance so that rate regulation is not warranted at this time. The Model NAIC Cost Disclosure Regulation was designed to inform consumers and foster even a higher degree of competition than what exists currently.

After thoroughly discussing all aspects of the subject, it was concluded that it is not feasible or desirable to develop a model regulation or recommend to state members a regulation covering expense limitations.

The task force feels it has completed the charge given to it by the Life Insurance (C3) Subcommittee and asks to be dismissed.

Hon. Dick L. Rottman, Chairman, Nevada; Thomas J. Kelly, New York; Hon. Harry V. Jump, Ohio; Ramon Estefania, South Carolina; Ted Becker, Texas.

Life Insurance Replacement (C3) Industry Advisory Committee
Report with Proposed Revised Model Regulation

November 7, 1977

The Industry Advisory Committee to the NAIC Replacement Regulation Task Force was formed in April, 1977 to study the subject of replacement of life insurance and make recommendations to the task force. The following individuals were appointed by Nebraska's Director of Insurance, Berri Balka, Chairman of the task force, to serve on the committee: Ronald J. Doane, (Chairman) Vice President, The Equitable Life Assurance Society of the United States; William M. Symon, Jr. (Secretary), Secretary and General Counsel, Old American Insurance; Carl T. Barnes, Policy Analyst, Kansas City Life Insurance Co.; J. Stephen Beckman, President, United Investors Life Insurance Co.; Jack Bobo, President, National Association of Life Underwriters; H. James Douds, General Counsel, National Association of Life Underwriters; H. Daniel Gardner, Assistant General Counsel, Northwestern Mutual Life Insurance Co.; Edwin F. Jackson, Executive Vice President and General Counsel, American Republic Insurance Co.; John J. Jaskot, Senior Vice President, United Services Life Insurance Co.; John M. Jex, Second Vice President/Governmental and Legislative Affairs, New York Life Insurance Co.; Don Leising, CLU, Security Mutual Life Insurance Co.; Michael D. Monette, Associate Corporate Counsel, Colonial Penn Life Insurance Co.; John P. States, Associate Counsel, State Farm Life Insurance Co.; William R. Toler, Vice President/Operations, MFA Life Insurance.

The advisory committee held its organizational meeting on April 25, 1977 at the NAIC Zone V meeting in Omaha, Nebraska. Two decisions resulted from it: (1) Replacements cannot be prohibited because of such legal principles as freedom of contract and should not be prohibited in any event since there are instances where it would benefit an insured to replace an existing policy with a new one; and (2) Replacements should be subject to regulatory disclosure standards since the transaction can be complicated, an unfair trade practice can arise, and the buyer should have the benefit of all relevant and useful information about the policies involved before making a decision.

A joint meeting of the task force and advisory committee was held on June 5, 1977 in Minneapolis, Minnesota. At this meeting, the committee reported its initial conclusions and asked the task force for direction on how it should proceed with its assignment. The requested guidance was that the committee draft a Model Replacement Regulation that dovetailed with the NAIC Model Life Insurance Solicitation Regulation, but included alternative provisions that could be used by any jurisdiction that did not promulgate the Model Solicitation Regulation – see report of the Life Insurance (C3) Subcommittee meeting held on June 7, 1977.

Having received its charge, the committee met in Madison, Wisconsin on July 21, Kansas City, Missouri on September 22, and again in Madison on October 10. A discussion draft of a Model Replacement Regulation was sent to the members of the task force in early October. This was followed by an oral explanation presented to them at a joint meeting of the task force and advisory committee, held in open session, in Madison on October 11.

The proposed Model Replacement Regulation attached to this report is very similar to the discussion draft. It is being submitted herewith by the industry advisory committee to the task force with the recommendation that it be presented to and adopted by the NAIC. Following is an explanation of its provisions, and in those cases where it is deemed needed, an explanation of the predominant reasons the committee decided upon the course of action that it is recommending.

Overview

The proposed regulation departs significantly from the present Model Replacement Regulation. It contains many new concepts. The most prominent is recognition that while the replacement of existing life insurance may be detrimental to insureds in many cases, it may, in some instances, benefit an insured to replace existing life insurance. As a result, the provisions of the proposed Replacement Regulation focus on demanding that all pertinent information be fully disclosed to the insured/buyer in a fair and accurate manner, and provide ample time for him to review the information before making a final decision.

Most of the changes associated with the proposed regulation emanated from the committee's understanding and acceptance of this premise. For instance, insurers rather than agents will be obligated to provide the insured/buyer with data concerning the replacement policy and the policy to be replaced. The replacing insurer must furnish the buyer with a disclosure document for its policy, and the existing insurer, if it makes any effort to conserve its policy, must provide comparable information to its insured. This gives greater assurance that the information the insured/buyer will be receiving is accurate and gives each insurer the opportunity to put forth its case fair and square. It is also the key that makes it possible to coordinate the Model Replacement Regulation with the Model Solicitation Regulation.

Another example is the notices regarding replacement of life insurance. They have been recast to present a more balanced and fair picture of the pros and cons of replacement.

Finally, the proposed regulation includes strong encouragement to insurers to provide a twenty-day money-back guarantee with any policy that is intended to replace existing insurance. (See page 12 for the reason the money-back guarantee was not mandated.) The twenty-day period commences from the time the policy is delivered to the insured/buyer. Together with other requirements in the regulation, this will allow an existing insurer ample time to prepare and present its disclosure document and also give the insured/buyer a reasonable period of time to review the information received from both companies before making a final decision.

Details

Following is a section-by-section analysis of the more important provisions in the proposed regulation.

Section 3. Definition of Replacement

The new definition of replacement is more inclusive than the one contained in the present Model Replacement Regulation. For example, a replacement transaction occurs when new life insurance is to be purchased and an existing policy is reissued with a reduction in cash value. Similarly, if more than twenty-five percent of an existing policy's loan value is borrowed or pledged as collateral to pay for the new insurance, the regulation's requirements are triggered.

Under the present model, the existing policy could be reissued with a reduction in cash value, or its loan values could be borrowed on, in an amount up to 50 percent of those values. The overriding consideration for broadening the definition was not done with the thought that replacements are wrong. The decision was based on recognition of the need to require full disclosure whenever values in an existing policy are significantly affected by reason of the purchase of new insurance.

The proposed definition also adds a tougher standard for compelling agents to comply with the requirements of the regulation. The present model states that the agent must know that a replacement transaction is or will take place. It is proposed that this be changed to say that the agent knew or should have known that a replacement was involved. The should-have-known test is commonly used in law to establish a standard of conduct. It enables a Commissioner to objectively apply a standard of practice that a licensed agent must follow.

Consideration was given to changing the language to the agent knew or had reason to believe a replacement would result. This test was rejected as being too subjective a standard, one which would create the, perhaps, insurmountable problem of proof of the agent's particular state of mind and actual knowledge in each individual case.

Section 4. Other Definitions

This is a new section which defines many of the important terms used throughout the regulation. Most of them are self-explanatory. The definitions, however, deserve brief comment.

The definition of existing life insurance, in effect, expands the definition of replacement. It brings cases on which a conditional receipt has been issued and policies that are still within a money-back guarantee period within the scope of the regulation. This provision has special significance in states which have not promulgated the Model Solicitation Regulation since it will enable the buyer to get pertinent information in comparable form from both companies when a competitive situation occurs.

Additional insurance purchased under a dividend option is specifically excluded from the definition of existing insurance. The present model regulation does not apply when dividend additions are cashed in and used to purchase a new policy. The new language, therefore, simply clarifies what has been the accepted practice.

The definition of sales proposal has been refined from what it appears to have meant under the present model. The term is not precisely defined in the present model, but could be interpreted as meaning anything and everything used in the sale. The committee considered including such a broad definition but decided it was unwieldy to enforce and administer, and represented an improper disparity with sales proposals used in situations where no replacement was involved.

Sales proposal has been defined in the proposed regulation to mean only those sales aids that are prepared for a particular insured/buyer which a replacing insurer or its agent uses to encourage replacement or an existing insurer or its agent uses to persuade the insured/buyer not to replace its policy. While this definition is narrower than the present requirement for replacing insurers and their agents, it is broader in that it now brings existing insurers and their agents within the definition. Dual application of the requirements related to this definition are necessary to assure that regulatory officials are able to determine that both existing and replacing insurers are operating properly where there is a replacement.

Section 5. Exemptions

The exemptions provision under the proposed regulation is drafted to parallel as much as possible the exemptions included in the Model Solicitation Regulation. This is essential since the information required to be disclosed by the replacement regulation is consistent with the information required by the solicitation regulation.

In this connection, it is important to keep in mind that the NAIC has undertaken the task of developing solicitation regulations for four of the exempted products: annuities, credit life insurance, group life insurance, and variable life insurance – see Vol. I of the 1976 NAIC Proceedings, at page 523. Once the disclosure requirements applying to the sale of these products is finalized, the replacement regulation can be easily adapted to bring them within its scope.

Consequently, it is perhaps more appropriate to characterize the four exemptions referred to above as being temporary rather than permanent. In any event, the committee feels very strongly that if any of the four products is removed from being exempt, then detailed provisions setting forth what basic information should be disclosed by the replacing and existing insurers must be drafted and incorporated into the regulation. The only instances where a requirement to disclose undefined material facts regarding replacements makes some sense is when the transaction comes within section 5C. This is a carryover from the present model and is appropriate because of the sophistication of the buyer.

The committee took a hard look at the two remaining exemptions which appear in both the present and proposed model regulations, sections 5E and F. It concluded they were appropriate. The exercise of a contractual change or conversion privilege under an existing policy deserves exemption since the policy was sold and bought with these flexible features for the purpose of exercising them. It was the intent of the buyer that he have the option to automatically replace his policy with another form at some point in the future. It was also felt that the administrative burden placed on companies if they were forced to consider these transactions as replacements might cause them to delete them from their policy forms, thereby having a stifling effect on the development of innovative, flexible products that could be useful to the public.

Section 6. Duties of Agents

The duties of the agent are changed considerably under the proposed regulation. Agents will no longer be required to complete the comparison statement required by the existing model and submit it to the buyer. A study conducted by Professor William Scheel for the Wisconsin Insurance Department shows that many comparison statements include erroneous information or are incomplete.

The numerical data is frequently incorrect, particularly where the existing insurance is a participating policy. This deficiency in the existing model should be corrected by having both the replacing and existing insurers furnish information regarding their own policy to the insured/buyer.

The committee rejected the idea of having a comparison statement with only rhetorical questions. The Scheel study indicates that the answers to such questions currently included in comparison statements are often misleading, or at best, so general as to be of little value. The better approach is to have the "sales proposals," if any, used by replacing or existing insurers or their agents maintained on file in the respective companies for regulatory scrutiny with respect to fairness and accuracy.

The duties of the replacing insurers' agents are increased in one respect by the proposed regulation. These agents will have to identify the existing insurer and the policy numbers of the policies that will or may be replaced. This will facilitate the existing insurers' conservation efforts by reducing the time it must now use to determine which of its policyowners is involved when it receives notice from the replacing insurer. If a policy has not yet been issued for the existing insurance so no policy number has been assigned, then the agent is obligated to provide some other type of specific identification information, such as an application or receipt number.

Section 7. Duties of Replacing Insurers

As mentioned previously, one of the most significant shifts of responsibility regarding disclosure in replacement transactions is the requirement that the replacing insurer, rather than its agent, be responsible for furnishing information concerning the new policy. The format in which the information is to be provided is the same as is required by the Model Solicitation Regulation.

If a jurisdiction has not promulgated the Model Solicitation Regulation, an alternative provision has been inserted. Essentially, it contains all of the information required by the Model Solicitation Regulation, except interest-adjusted index figures. Evidence made available to the committee indicated that at this time the use of the interest-adjusted method or any other cost comparison method should not be used to compare dissimilar policies. If such comparisons were made they could mislead the buyer. Consequently, since many replacement transactions involve the comparison of dissimilar policies, the committee decided not to require interest-adjusted figures to be disclosed.

On the other hand, since interest-adjusted figures could be useful for comparing similar policies, the committee decided it could not include a prohibition of their inclusion in the disclosure document (referred to as policy summary throughout this report), but rather could only require that a caveat be made when they were furnished that they should be used only for comparing the relative costs of similar policies.

In contrast to the comparison statement required by the present model, the proposed regulation does not demand that a rigid format for presenting the information about the new and old policies be used. Instead, it uses the same standard as is required by the solicitation regulation, i.e., that the required information must not be minimized or obscured – see section 4(G) 11 of the Model Solicitation Regulation.

As with the development of the solicitation regulation, considerable thought was given to permitting the use of a flexible standard. The conclusion to adopt such a standard was based primarily on two reasons. First, an acceptable rigid format that would accurately disclose the particular aspects of all policies could not be satisfactorily developed. Second, this being the case, there was little likelihood that agents or insurers would attempt to focus the buyer's attention on such a document if it were required since it would not fully disclose all of the benefits and provisions of the policy being offered.

Since the solicitation regulation recognized that the disclosure document could be modified to include the full details about a policy in addition to those that were required to be disclosed, the committee decided that the same standard could be applied to replacement transactions so long as the fundamental test remained that the required information to be disclosed could not be minimized or obscured.

Another important feature in this section is the provision which will permit the insured/buyer ample opportunity to receive and review information about both the replacing policy and the existing insurance before making a final decision. The proposed regulation is drafted to strongly encourage replacing insurers to provide a twenty-day money-back guarantee with policies that may or will replace existing insurance. If they elect not to do so, then they must delay issue of their policies until twenty days after they have notified the existing insurer.

The committee considered mandating that a twenty-day money-back guarantee be included in policies that replace existing insurance. This approach had to be rejected since it would not survive a legal challenge. The authority to compel insurers to include "required provisions" in their policies rests with the legislatures and cannot be accomplished by regulation, absent specific statutory authority.

Where the replacing insurer does provide a twenty-day money-back guarantee, it must notify the existing insurer within three working days after it issues the policy. The notification must be in writing and must include the name of the insured/buyer, the policy numbers or other identifying information of the existing insurance that may or will be replaced and the policy summary the replacing insurer presented to the insured/buyer.

Consideration was given to having notification to the existing insurer occur shortly after the replacing insurer itself received notice that its policy would or may replace existing insurance. This approach was deemed unfeasible for several reasons.

First, the replacing insurer could only give notice of replacement at such an early stage. It would not be capable of providing an appropriate policy summary that soon. In many instances, additional underwriting information would be needed before the replacing insurer could decide whether it would issue a policy, and if so, what policy it was willing to write. For this reason, most companies will not prepare the policy summary until the very end of the policy issue process. This is consistent to what most companies are doing when complying with the solicitation regulation.

Second, simply providing the existing insurer with notice of the replacement transaction at an early stage would not benefit the insured/buyer as much as if the replacing insurer were to send the notice and its policy summary to the existing insurer and the latter had ample time to prepare and present a comparable policy summary to the insured/buyer. In this regard, it should be noted that the twenty-day money-back guarantee commences with delivery of the policy and that experience among companies that currently permit their agents to deliver policies they issue indicates that delivery very often occurs sometime between fifteen and twenty-five days after the policy was issued. Realistically, the money-back guarantee runs from between thirty-five days after issue, which would seem to be more than ample time for the insured/buyer to receive and review pertinent information about the existing insurance from the existing insurer.

Another significant aspect of this section is the requirement that replacing insurers maintain a replacement register, cross-indexed by replacing agent and the existing insurer to be replaced. It was concluded that such a register would highlight extraordinary replacement activity of agents, particularly those who were previously under contract with another carrier. This device, therefore, presents itself as a sound, self-regulatory (or in its absence, formal regulatory) response to prevent "churning" of existing insurance.

Section 8. Duties of Insurers with Respect to Direct-Response Sales

A new section covering direct-response sales has been included to make the regulation responsive to this form of marketing.

If direct-response solicitation material does not encourage buyers to replace existing insurance, the insurer, when notified that a replacement will occur, need only mail the applicant the appropriate "Notice Regarding Replacement of Life Insurance" when it sends the policy. This approach is warranted since there is no pressure being put on the buyer to replace existing insurance, as might be the case when an agent is involved in the sale of a policy.

However, if the direct-response sales solicitation material illustrates the benefits of or encourages the reader to replace existing insurance, the insurer, with one exception, will be required to follow all of the disclosure procedures with which replacing insurers must comply. The committee felt that this type solicitation material would produce substantial motivation to an insured/buyer to replace existing insurance so as to warrant its being treated the same as where an agent encourages an insured/buyer to replace existing coverage.

The one exception is where the applicant fails or refuses to identify the existing insurer. In this situation, the insurer need only mail the appropriate "Notice Regarding Replacement of Life Insurance" to the insured at the time it sends the policy. This approach is sound since the applicant is clearly making a voluntary decision not to provide the requested information.

Section 9. Duties of the Existing Insurer

This section is also new. The present model does not place any responsibility on existing insurers that relates to their conservation efforts. The proposed regulation establishes requirements with respect to these activities.

If the existing insurer or its agent makes any effort to contact the insured/buyer to conserve the existing life insurance, the existing insurer must furnish the insured/buyer with a policy summary within twenty days from the date it received notice from the replacing insurer that its insurance was being replaced.

The policy summary must include comparable information to the one the replacing insurer sent to the insured/buyer. It, therefore, is patterned after the policy summary required by the Model Solicitation Regulation, although it also includes current policy loan and dividend information.

The existing insurer is required to send to the replacing insurer a copy of the policy summary it gives to the insured/buyer within three working days of the date the policy summary is mailed to either the insured/buyer or the existing insurer's agent. This allows all parties involved in the transaction to have the same knowledge of the basic information being disclosed. The timing requirement here is notably on a parity with the notification requirement imposed on the replacing insurer to furnish its policy summary to the existing insurer.

The committee devoted a great deal of time and discussion to whether existing insurers should be compelled to furnish a disclosure document in all cases. Admittedly, this would assure that the insured/buyer receives comparable information from both companies in all instances.

On the other hand, there is little logic to compel an existing insurer to make a conservation effort if, after reviewing what the replacing insurer is offering, it determines that the replacing insurer's proposal is a better program for the insured/buyer than the existing insurance. Furthermore, an all-inclusive requirement would cause existing insurers to incur unnecessary expenses – which costs could be substantial since it is anticipated that most companies will have to prepare the policy summary for existing insurance manually.

The better approach is to strive for establishing a competitive environment. This will be accomplished if enough time is given to companies to get their disclosure documents to the insured/buyer. The proposed regulation does this. The weaknesses in the present model, whereby existing insurers are not given ample opportunity to advise their policyowners in replacement transactions, has been corrected. Under the proposed regulation, there will be many more cases where the insured/buyer receives timely information from both the replacing and existing insurers.

Section 10. Penalties

This section is substantially the same under both the proposed regulation and the present model.

Notices Regarding the Replacement of Life Insurance

As mentioned earlier, the language in the notices has been reworded to provide a more balanced and fairer presentation of the pros and cons of replacement. Also, instead of one notice being used to serve all cases, there are now three. Exhibit A is to be used when the replacing insurer is replacing another company's policy. Exhibit B is to be furnished when the replacing insurer is replacing one of its own policies. Exhibit C applies in direct-response sales.

Each notice includes an alternative paragraph for replacing insurers that provide a twenty-day money-back guarantee, should they choose to make this liberalization.

Conclusion

The advisory committee in submitting the proposed replacement regulation believes that it has satisfactorily met the specific mandate given to it by the NAIC in that the proposal is drafted to closely coordinate with the Model Life Insurance Solicitation Regulation.

Moreover, the members of the committee are convinced that the product of their effort has addressed the overall concerns involving replacement transactions. We believe that while no one company, or individual for that matter, may be totally satisfied with the proposed regulation being submitted, it is an affirmative and acceptable solution that seeks to serve the consumers' interest first and deals reasonably with agents and all types of insurers in terms of the requirements and responsibilities it imposes on them.

Ronald J. Doane, Chairman, Equitable Life Assurance Society of the United States; William M. Symon, Jr., Secretary, Old American Insurance; Carl T. Barnes, Kansas City Life Insurance Company; J. Stephen Beckman, United Investors Life Insurance Company; Jack Bobo, National Association of Life Underwriters; H. James Douds, National Association of Life Underwriters; H. Daniel Gardner, Northwestern Mutual Life Insurance Company; Edwin F. Jackson, American Republic Insurance Company; John J. Jaskot, United Services Life Insurance Company; John M. Jex, New York Life Insurance Company; Don Leising, Security Mutual Life Insurance Company; Michael D. Monette, Colonial Penn Life Insurance Company; John P. States, State Farm Life Insurance Company; William R. Toler, MFA Life Insurance.

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PROPOSED REVISED
NAIC MODEL LIFE INSURANCE REPLACEMENT REGULATION

Section 1. Statutory Authority

This regulation is promulgated by (title of supervisory authority) to implement section _________ of the insurance laws:

Section 2. Purpose

The purpose of this regulation is:

A. To regulate the activities of insurers and agents with respect to the replacement of existing life insurance;

B. To protect the interests of life insurance policyowners by establishing minimum standards of conduct to be observed in the replacement or proposed replacement of existing life insurance by:

1. Assuring that the policyowner receives information with which a decision can be made in his or her own best interest;

2. Reducing the opportunity for misrepresentation and incomplete disclosures; and

3. Establishing penalties for failure to comply with the requirements of this regulation.

Section 3. Definition of Replacement

"Replacement" means any transaction in which new life insurance is to be purchased, and it is known or should be known to the proposing agent, or to the proposing insurer if there is no agent, that by reason of such transaction existing life insurance has been or is to be:

A. Lapsed, forfeited, surrendered, or otherwise terminated;

B. Converted to reduced paid-up insurance, continued as extended term insurance, or otherwise reduced in value by the use of nonforfeiture benefits or other policy values;

C. Amended so as to effect either a reduction in benefits or in the term for which coverage would otherwise remain in force or for which benefits would be paid;

D. Reissued with any reduction in cash value; or

E. Pledged as collateral or subjected to borrowing, whether in a single loan or under a schedule of borrowing over a period of time, in amounts exceeding twenty-five percent (25%) of the loan value set forth in the policy.

Section 4. Other Definitions

A. "Existing Life Insurance" means any life insurance in force including life insurance under a binding or conditional receipt for a life insurance policy that is within an unconditional refund period, but excluding life insurance obtained through the exercise of a dividend option.

B. "Existing Insurer" means the insurance company whose existing life insurance is or will be changed or terminated in such a manner as described within the definition of "replacement."

C. "Replacing Insurer" means the insurance company that issues a new policy which is a replacement of existing life insurance.

D. "Cash Dividend" means the current illustrated dividend which can be applied toward payment of the gross premium.

E. "Generic Name" means a short title which is descriptive of the premium and benefit patterns of a policy or a rider.

F. "Conservation" means any attempt by the existing insurer or its agent to continue existing life insurance in force when it has received proper notice as required by section 7C 4 of this regulation from a replacing insurer that the existing life insurance is or will be replaced.

G. "Sales Proposal" means individualized sales aids of all kinds which are designed to justify the replacement or conservation of existing life insurance and used by an insurer, agent or broker for presentation to policyowners. Sales aids of a generally descriptive nature, which are maintained in the insurer's advertising compliance file, shall not be considered a sales proposal within the meaning of this definition.

H. "Direct-Response Sales" means any sale of life insurance where the insurer does not utilize an agent in the sale or delivery of the policy.

Section 5. Exemptions

Unless otherwise specifically included, this regulation shall not apply to:

A. Annuities;

B. Individual credit life insurance;

C. Group life insurance, group credit life insurance and life insurance policies issued in connection with a pension, profit sharing or other benefit plan qualifying for tax deductibility of premiums, provided, however, that as to any plan described in this subsection, full and complete disclosure of all material facts shall be given to the administrator of any plan to be replaced;

D. Variable life insurance under which the death benefits and cash values vary in accordance with unit values of investments held in a separate account; or

E. Where the application is made to the existing insurer that issued the existing life insurance and a contractual change or conversion privilege is being exercised; or

F. When the existing life insurance is a nonconvertible term life insurance policy which will expire in five years or less and cannot be renewed.

Section 6. Duties of Agents

A. Each agent shall submit to the replacing insurer with or as part of each application for life insurance:

    1. A statement signed by the applicant as to whether or not such insurance will replace existing life insurance; and

    2. A signed statement as to whether or not the agent knows replacement is or may be involved in the transaction.

B. Where a replacement is involved, the agent shall:

    1. Obtain with or as part of each application a list of all existing life insurance to be replaced. Such existing life insurance shall be identified by name of insurer and the policy number. In the event that a policy number has not been assigned by the existing insurer, alternative identification information, such as an application or receipt number, must be listed.

2. Present to the applicant, not later than at the time of taking the application, a "Notice Regarding Replacement of Life Insurance" in the form substantially as described in Exhibits A or B, whichever is applicable. The notice must be signed by the agent and receipt of it acknowledged by the applicant. A copy of the notice must be left with the applicant.

3. Submit to the replacing insurer with the application, a copy of the "Notice Regarding Replacement of Life Insurance," signed by the agent and receipt of it acknowledged by the applicant, a copy of all sales proposals used for presentation to the applicant and a separate statement including the information described in section 6B 1, unless such information is included in the application.

Section 7. Duties of Replacing Insurers

Each replacing insurer shall:

A. Inform its field representatives of the requirements of this regulation.

B. Require with or as part of each completed application for life insurance:

1. A statement signed by the applicant as to whether or not such insurance will replace existing life insurance; and

2. A statement signed by the agent as to whether or not he or she knows replacement is or may be involved in the transaction.

C. Where a replacement is involved:

1. Require with or as part of each application for life insurance a list of all of the applicant's existing life insurance to be replaced. Such existing life insurance shall be identified by name of insurer and the policy number. In the event that a policy number has not been assigned by the existing insurer, alternative identification information, such as an application or receipt number, must be listed.

2. Require from the agent with the application for life insurance a copy of the "Notice Regarding Replacement of Life Insurance" signed by the agent and receipt of it acknowledged by the applicant, and a copy of all sales proposals used for presentation to the applicant.

3. Unless otherwise modified by the provisions of sections 7C 4 or 5 of the regulation, furnish to the applicant a policy summary in accordance with the provisions of the Life Insurance Solicitation Regulation.

(Alternative Provision, Section 7C 3)

If the NAIC Model Life Insurance Solicitation Regulation has not been promulgated, then, for the purpose of this regulation, the following alternative provision should be used:

3. *Unless otherwise modified by the provisions of sections 7C 4 or 5 of this regulation, furnish the applicant with a policy summary at or prior to the time of policy delivery. For the purpose of this regulation, a policy summary means a written statement describing the elements of the policy including, but not limited to:*

   a. *The name and address of the insurance agent or if no agent is involved, a statement of the procedure to be followed in order to receive responses to inquiries regarding the policy summary.*

   b. *The full name and home office or administrative office address of the company in which the life insurance policy is to be or has been written.*

   c. *The generic name of the basic policy and each rider.*

d. *The following amounts, where applicable, for the first five policy years, the tenth and twentieth policy years, and at least one age from sixty through sixty-five or maturity, whichever is earlier:*

1. *The annual premium for the basic policy.*

2. *The annual premium for each optional rider.*

3. *Guaranteed amount payable upon death, at the beginning of the policy year regardless of the cause of death other than suicide, or other specifically enumerated exclusions, which is provided under the basic policy and each rider shown separately.*

4. *Total guaranteed cash surrender values at the end of the year with values shown separately for the basic policy and each rider.*

5. *Cash dividends payable to the end of the year with values shown separately for the basic policy and each rider. (Dividends need not be displayed beyond the twentieth policy year.)*

6. *Guaranteed endowment amounts payable under the policy which are not included under guaranteed cash surrender values above.*

e. *A policy summary which includes dividends shall also include a statement that dividends are based on the company's current dividend scale and are not guaranteed.*

f. *The effective policy loan annual percentage interest rate, if the policy contains such a loan provision, specifying whether this rate is applied in advance or in arrears. If the policy loan interest rate is variable, the policy summary is to include the maximum annual percentage rate.*

g. *The date on which the policy summary is prepared.*

h. *A statement to the effect that the presentation does not recognize that, because of interest, a dollar in the future has less value than a dollar today, unless the policy summary includes index figures which recognize the time value of money. If index figures are included in the policy summary, the applicant must be notified at the time the policy summary is delivered that such figures should only be used for comparing the relative costs of similar policies.*

The policy summary must consist of a separate document. All information required to be disclosed must be set out in such a manner as to not minimize or render any portion thereof obscure. Any amounts which remain level for two or more years of the policy may be represented by a single number if it is clearly indicated what amounts are applicable for each policy year. Amounts in item "d" in this section shall be listed in total, not on a per thousand nor per unit basis. If more than one insured is covered under one policy or rider, guaranteed death benefits shall be displayed separately for each insured or for each class of insureds if death benefits do not differ within the class. Zero amounts shall be displayed as zero and shall not be displayed as a blank space.

4. Delay, if it is not also the existing insurer, the issue of its policy for twenty days after it sends the existing insurer a written communication that includes the name of the insured, the identification information with respect to the existing life insurance to be replaced that it obtained pursuant to section 7C 1, and a copy of the policy summary, unless it provides in its "Notice Regarding Replacement of Life Insurance" and in either its policy or in a separate written notice that is delivered with the policy that the applicant has a right to an unconditional refund of all premiums paid, which right may be exercised within a period of twenty days commencing from the date of delivery of the policy, and it sends the written communication required by this section to the existing insurer within three working days of the date its policy is issued, in which event the replacing insurer may issue its policy immediately.

5. Provide, if it is also the existing insurer, the policyowner a policy summary for the new policy prepared in accordance with section 7C 3, prior to accepting the applicant's initial premium or premium deposit, unless the replacing insurer provides in its "Notice Regarding Replacement of Life Insurance" and in either its policy or in a separate written notice that is delivered with the policy that the applicant has a right to an unconditional refund of all premiums paid, which right may be exercised within a period of twenty days commencing from the date of delivery of the policy, in which event, the replacing insurer must furnish the policy summary at or prior to delivery of the policy.

6. Maintain copies of the written communication required by section 7C 4, the "Notice Regarding Replacement of Life Insurance," the policy summary, and all sales proposals used, and a replacement register, cross indexed, by replacing agent and existing insurer to be replaced, for at least three years or until the conclusion of the next succeeding regular examination by the insurance department of its state of domicile, whichever is later.

Section 8. Duties of Insurers With Respect to Direct-Response Sales

Each insurer shall:

A. Inform its responsible personnel of the requirements of this regulation.

B. Require with or as part of each completed application for life insurance a statement signed by the applicant as to whether or not such insurance will replace existing life insurance.

C. Where no replacement is proposed by an insurer in the solicitation of a direct-response sale and a replacement is involved:

1. At the time the policy is mailed to the applicant, include a "Notice Regarding Replacement of Life Insurance" in a form substantially as described in Exhibit C.

D. Where a replacement is proposed by an insurer in the solicitation of a direct-response sale and a replacement is involved:

1. Request from the applicant with or as part of the application a list of all existing life insurance to be replaced. Such existing life insurance shall be identified by name of insurer.

2. If the applicant furnishes the names of the existing insurers, then the replacing direct-response insurer shall mail the applicant a "Notice Regarding Replacement of Life Insurance" in a form substantially as described in Exhibit C within three working days after receipt of the application and shall comply with all of the provisions of sections 7C 3, 4, 5 and 6, except that it need not maintain a replacement register required by section 7C 6.

3. If the applicant does not furnish the names of the existing insurers, then the replacing direct-response insurer shall at the time the policy is mailed to the applicant, include a "Notice Regarding Replacement of Life Insurance" in a form substantially as described in Exhibit C.

Section 9. Duties of the Existing Insurer

Each existing insurer which undertakes a conservation effort shall:

A. Furnish the policyowner with a policy summary for the existing life insurance within twenty days from the date it receives the written communication required by section 7C 4 from the replacing insurer. Such policy summary shall be completed in accordance with the provisions of the Life Insurance Solicitation Regulation, except that information relating to premiums, cash values, death benefits and dividends, if any, shall be computed from the current policy year of the existing life insurance. The policy summary shall include the amount of any outstanding policy indebtedness, the sum of any dividend accumulations or additions, and may include any other information that is not in violation of any regulation or statute. Life insurance cost index and equivalent level annual dividend figures need not be included in the policy summary. If index figures are included in the policy summary, the policyowner must be notified at the time the policy summary is delivered that such figures should only be used for comparing the relative costs of similar policies.

(Alternative Provision, Section 9A)

If the NAIC Model Life Insurance Solicitation Regulation has not been promulgated, then, for the purpose of this regulation, the following alternative provision should be used for A:

A. *Furnish the policyowner with a policy summary for the existing life insurance within twenty days from the date it receives the written communication required by section 7C 4 from the replacing insurer. Such policy summary shall include all of the information required in section 7C 3, except that information relating to premiums, cash values, death benefits and dividends, if any, shall be computed from the current policy year of the existing life insurance. The policy summary shall include the amount of any outstanding policy indebtedness, the sum of any dividend accumulations or additions, and may include any other information that is not in violation of any regulation or statute.*

B. Furnish the replacing insurer with a copy of the policy summary for the existing life insurance within three working days of the date that the policy summary is sent by the existing insurer to either its agent or directly to the policyowner.

C. Maintain a file containing the following:

   1. Written communications required by section 7C 4 received from replacing insurers; and

   2. Copies of policy summaries prepared pursuant to section 9A, and all sales proposals used.

   This material shall be indexed by replacing insurer and held for three years or until the conclusion of the next regular examination conducted by the insurance department of its domicile, whichever is later.

Section 10. Penalties

A. Any insurer, agent, representative, officer or employee of such insurer failing to comply with the requirements of this regulation shall be subject to such penalties as may be appropriate under the insurance laws of ______________.

B. This regulation does not prohibit the use of additional material other than that which is required that is not in violation of this regulation or any other _________ statute or regulation.

C. Policyowners have the right to replace existing life insurance after indicating in or as part of the applications for life insurance that such is not their intention; however, patterns of such action by policyowners who purchase the replacing policies from the same agent shall be deemed prima-facie evidence of the agent's knowledge that replacement was intended in connection with the sale of those policies, and such patterns of action shall be deemed prima-facie evidence of the agent's intent to violate this regulation.

(Exhibit A: To be used where the existing and proposed policies are written by different companies.)

(Name, address and telephone number of the insurance company)

IMPORTANT NOTICE REGARDING REPLACEMENT OF LIFE INSURANCE

Our agent is recommending to you that you purchase a life insurance policy from us. In connection with this purchase, you have indicated, either as a result of his recommendation or at your own initiative, that you may terminate or change your existing policy issued by another insurance company or that you may obtain a loan from that company against your policy to pay premiums on the proposed policy. Any of these actions is a replacement of life insurance, and this notice is required. Please read it carefully.

Whether it is to your advantage to replace your existing insurance coverage, only you can decide. It is in your best interest, however, to have adequate information before your decision to replace your present coverage becomes final so that you may understand the essential features of the proposed policy and of your existing insurance coverage.

To this end, we are required to give you a policy summary of the proposed policy no later than when the policy is delivered to you. In addition, we are required to notify the insurance company that issued your existing policy. That company may then furnish you with a similar policy summary of your existing policy. You may want to contact that company or its agent for additional information and advice or discuss your purchase with other advisors. The information you receive will be of value to you in reaching a final decision.

After we have received your application and notified the other insurance company (which we are required to do by state regulation at the time we issue your policy), you will have twenty days from the date the proposed policy is delivered to you to cancel the policy issued on your application and receive back all payments you made to us.

(Alternate paragraph if 20 day money-back guarantee is not provided)

Please note that, by state regulation, we must delay the issuance of any policy which is intended to replace any of your existing insurance for twenty days from the date on which we send your existing insurer notification that their policy will be replaced.

You should recognize that a policy which has been in existence for a period of time may have certain advantages to you over a new policy. If the policy coverages are basically similar, the premiums for a new policy may be higher because rates increase as your age increases. Under your existing policy, the period of time during which the issuing company could contest the policy because of a material misstatement or omission on your application, or deny coverage for death caused by suicide, may have expired or may expire earlier than it will under the proposed policy. Your existing policy may have options which are not available under the policy being proposed to you or may not come into effect under the proposed policy until a later time during your life. Also, your proposed policy's cash values and dividends, if any, may grow slower initially because the company will incur the cost of issuing your new policy. On the other hand, the proposed policy may offer advantages which are more important to you.

If you are considering borrowing against your existing policy to pay the premiums on the proposed policy, you should understand that in the event of your death the amount of any unpaid loan, including unpaid interest, will be deducted from the benefits or your existing policy thereby reducing your total insurance coverage.

CAUTION

If, after studying the information made available to you, you do decide to replace the existing life insurance with our life insurance policy, you are urged not to take action to terminate or alter your existing life insurance coverage until after you have been issued the new policy, examined it and have found it to be acceptable to you. If you should terminate or otherwise materially alter your existing coverage and fail to qualify for the life insurance for which you have applied, you may find yourself unable to purchase other life insurance or able to purchase it only at substantially higher rates.

by ______________________________

Agent or Employee

I have received and have read a copy of this Replacement Notice.

(Signed) ______________________________ Date ______________________________

Applicant

(Exhibit B: To be used where the existing and proposed policies are written by the same company.)

(Name, address and telephone number of the insurance company)

IMPORTANT NOTICE REGARDING REPLACEMENT OF LIFE INSURANCE

Our agent is recommending to you that you purchase a life insurance policy from us. In connection with this purchase, you have indicated, either as a result of his recommendation or at your own initiative, that you may terminate or change your existing policy issued by our company or that you may obtain a loan from our company against your existing policy to pay premiums on the proposed policy. Any of these actions is a replacement of life insurance and this notice is required. Please read it carefully.

Whether it is to your advantage to replace your existing insurance coverage, only you can decide. It is in your best interest, however, to have adequate information before your decision to replace your present coverage becomes final so that you may understand the essential features of the proposed policy and of your existing insurance coverage.

To this end, we are required to give you a policy summary of the proposed policy no later than when the policy is delivered to you. In addition, we will, at your request, furnish you with a similar policy summary of your existing policy. You may want to discuss your purchase with other advisors. The information you receive will be of value to you in reaching a final decision.

(Alternate paragraph if twenty-day money-back guarantee is provided)

After we have issued your policy, you will have twenty days from the date the new policy is delivered to you to cancel the policy issued on your application and receive back all payments you made to us.

You should recognize that a policy which has been in existence for a period of time may have certain advantages to you over a new policy. If the policy coverages are basically similar, the premiums for a new policy may be higher because rates increase as your age increases. Under your existing policy, the period of time during which our company could contest the policy because of a material misstatement or omission on your application, or deny coverage for death caused by suicide, may have expired or may expire earlier than it will under the proposed policy. Your existing policy may have options which are not available under the policy being proposed to you or may not come into effect under the proposed policy until a later time during your life. Also, your proposed policy's cash values and dividends, if any, may grow slower initially because the company will incur the cost of issuing your new policy. On the other hand, the proposed policy may offer advantages which are more important to you.

If you are considering borrowing against your existing policy to pay the premiums on the proposed policy, you should understand that in the event of your death, the amount of any unpaid loan, including unpaid interest, will be deducted from the benefits of your existing policy thereby reducing your total insurance coverage.

CAUTION

If, after studying the information made available to you, you do decide to replace the existing life insurance with our company with a new life insurance policy issued by our company, you are urged not to take action to terminate or alter your existing life insurance coverage until after you have been issued the new policy, examined it and have found it acceptable to you. If you should terminate or otherwise materially alter your existing coverage and fail to qualify for the life insurance for which you have applied, you may find yourself unable to purchase other life insurance or able to purchase it only at substantially higher rates.

By ______________________________
Agent or Employee

I have received and read a copy of this replacement notice.

(Signed) ______________________________ Date ______________________________
Applicant

EXHIBIT C

(Name, address and telephone number of the insurance company)

IMPORTANT NOTICE REGARDING REPLACEMENT OF LIFE INSURANCE

You have indicated that you intend to replace an existing life insurance policy or policies in connection with the purchase of our life insurance policy. As a result, we are required to send you this notice. Please read it carefully.

Whether it is to your advantage to replace your existing insurance coverage, only you can decide. It is in your best interest, however, to have adequate information before your decision to replace your present coverage becomes final so that you may understand the essential features of the proposed policy and your existing insurance coverage.

You may want to contact your existing life insurance company or its agent for additional information and advice or discuss your purchase with other advisors. The information you receive should be of value to you in reaching a final decision.

You should recognize that a policy which has been in existence for a period of time may have certain advantages to you over a new policy. If the policy coverages are basically similar, the premiums for a new policy may be higher because rates increase as your age increases. Under your existing policy, the period of time during which the issuing company could [contest the policy because of a material misrepresentation or omission concerning the medical information requested in your application, or] * deny coverage for death caused by suicide, may have expired or may expire earlier than it will under the proposed policy. Your existing policy may have options which are not available under the policy being proposed to you or may not come into effect under the proposed policy until a later time during your life. Also, your proposed policy's cash values and dividends, if any, may grow slower initially because the company will incur the cost of issuing your new policy. On the other hand, the proposed policy may offer advantages which are more important to you.

If you are considering borrowing against your existing policy to pay the premiums on the proposed policy, you should understand that in the event of your death, the amount of any unpaid loan, including unpaid interest, will be deducted from the benefits of your existing policy thereby reducing your total insurance coverage.

(Alternate paragraph if direct-response insurer's solicitation proposes replacement, and a twenty-day money-back guarantee is provided by the insurer.)

After we have issued your policy, you will have twenty days from the date the new policy is received by you to notify us you are cancelling the policy issued on your application and you will receive back all payments you made to us.

You are urged not to take action to terminate or alter your existing life insurance coverage until you have been issued the new policy, examined it and have found it acceptable to you.

*Use bracketed language only when the application asks health questions.

(C3) Task Force on Life Insurance Policy Language Simplification Standards

Denver, Colorado
October 27, 1977

The Simplification Standards Task Force was authorized by the (C3) Subcommittee at the June 1977 meeting of the NAIC in Minneapolis, Minnesota. The charge of the task force is to study and develop uniform standards for life insurance policy language simplification. Hon. William H. L. Woodyard III, Arkansas was appointed Chairman of the task force and the States of Colorado, Missouri, Nevada and Tennessee were appointed to serve on the task force.

The task force met on October 27, 1977 at Denver, Colorado jointly with members of the American Council of Life Insurance Committee on Policy Language Simplification Standards which had been asked to serve as an industry advisory committee. All states serving on the (C3) Task Force were present and were represented as follows: Hon. William H. L. Woodyard III, Chairman, Arkansas; W. Keith Sloan, Arkansas; Lee Stolberg, Colorado; Hon. Jerry B. Buxton, Missouri; Erma Edwards, Nevada; Howard Magill, Tennessee.

It was reported that the subject of "readable" policies has received a great deal of attention in recent years. This attention, which was first focused on property-casualty insurance, now includes life insurance. This trend is shown by the fact that 18 bills affecting life insurance policy simplification were introduced in 14 states in 1977. Three of these bills have been enacted so far, and a fourth is expected to pass.

The basic goals of these bills is the same -- to make policies easier to read and more understandable -- but the methods proposed to achieve that goal are quite different. For instance, some of the bills contain the standards which must be met, while others grant the Commissioner broad powers to adopt rules to set forth the standards. Of the three states which have passed laws on this subject, Arizona and Maryland require that standards be adopted by regulation, and Minnesota sets forth the basic standards in the law. A bill which is expected to pass in Massachusetts sets forth the standards in the law.

Other approaches which have been proposed are: (1) requirements that policies contain indexes or tables of contents; (2) requirements that policies be accompanied by simple language summaries or outlines of coverage; or (3) combinations of two or more of these approaches in the same bill.

The task force noted that in most cases the bills came from sources other than the Insurance Departments of those states. Many Commissioners apparently believe that good progress is being made toward policy language simplification and that a law or rule is not needed. But with a number of the 1977 bills carrying over to next year and with new introductions expected in other states, it is easy to see that there could soon be varying and conflicting standards among the states. The task force agreed that there is a critical need for uniformity among the states in policy approval standards. As one of the main objectives of the NAIC is to promote uniformity in legislation affecting insurance, the task force sees the need to act quickly to develop uniform standards for life insurance policy language simplification.

It was noted that the charge to the task force was expanded to include credit insurance at the request of the (C2) Subcommittee. Although the uniform standards for life insurance might be appropriate for use with credit insurance, careful consideration should be given to this matter. The task force agreed that credit insurance should be treated as an item for later study because of inadequate time to consider it now.

It was pointed out that uniform standards must be carefully drafted to avoid causing undue problems for both the industry and the regulators. For instance, most life insurance contracts are long term contracts as to which there is no change to increase premiums, so care must be taken to avoid requirements with respect to new policies that could cause unexpected results. There is a danger that changes from court tested language could lead to judgments for policy liabilities beyond those which were paid for by the insured and assumed by the insurer. The assumption of such unintended liabilities could threaten the financial soundness of companies. Policy language simplification is for the benefit of the insurance consumer and should not lead to greatly increased cost in the conduct of the business.

The task force agreed it was best to develop principles upon which a model bill should be based. It was decided that, in order to attain desired uniformity, a model bill dealing with policy language simplification standards should be drafted based upon the following principles:

1. The model bill should be prospective only and should not apply to policies which are in force or to forms used with such policies.

   The task force believes this is a basic principle which should be set forth in the model law. Although none of the bills introduced in 1977 would seem to apply to policies in force, the question of whether such laws would apply to forms used in the future with such policies seems to be unclear. The task force agreed it is necessary to include a specific exemption for forms, such as riders, endorsements or contractual exchange or conversion policies which have been approved prior to the effective date of the law and which would be used with existing policies. This exemption would avoid the problems that would occur if new forms had to be used with old policies based on different terminology and actuarial assumptions.

2. The model bill should contain the sole readability standards for life insurance policies in order to avoid conflicts with other laws.

   It was noted that New York had enacted a law this year requiring the use of understandable language in consumer agreements. Other states have also introduced similar bills. Although such bills do not seem to apply to insurance policies, they are very broad and often vague. If one of these bills were construed to apply to insurance, it would cause havoc for the industry and the regulator alike.

3. The model bill should not apply to group insurance or group annuities, with certain exceptions. The bill also should not apply to policies and contracts which would be subject to conflicting standards of federal regulatory agencies.

   The task force agreed that traditional or "true group" policies, such as model bill type groups and the group contracts subject to collective bargaining, should be exempted from readability requirements set forth in the model bill. The task force also agreed that the extent to which the model bill should apply to other forms of group insurance must be studied further.

   With respect to other exemptions, the task force agreed that forms which would be in conflict with state standards by reason of federal requirements should be exempted. Such an exemption will need to be carefully drafted.

4. The model should set forth the standards to determine what is a readable policy without resort to the rule-making process.

   The task force agreed that to accomplish the objective of nationally uniform standards, the standards should be set forth in the model bill itself. To avoid variation by subsequent rulemaking, any authorized rulemaking should be limited to the adoption of rules or guidelines which set forth procedures to implement the standards contained in the bill.

5. The standards set forth in the model bill must recognize that the policy is a legal contract and must permit flexibility and innovation in the development of policy forms and content.

   The task force believes it is essential that readability standards do not affect the coverage offered or the legal obligations intended to be assumed, and should affect only the readability and understandability of the policy. Many companies are making substantial progress in simplifying policy language and format, and others will have to do so as a competitive necessity if not for other reasons. In this climate the model bill should avoid over-regulation and establish the minimum standards which all must achieve.

6. The model bill should contain a requirement that policy forms must attain a reasonable score on the Flesche "reading ease" test or other recognized readability test. The bill should also (a) set forth the precise rules for applying the test; (b) grant the Commissioner authority to approve policy forms with a lower score if the lower score will provide either a more accurate reflection of the readability of a policy form or is warranted by the nature of a particular policy form or a type or class of policy forms; (c) provide that the Commissioner shall permit the use of substantially equivalent tests; (d) require that each policy form submitted for approval be accompanied by a certification of the overall test score achieved by that policy form; and (e) give the Commissioner for the purpose of confirming the accuracy of the score certified the right to require the submission of further information regarding the basis for the certification.

   The task force carefully considered whether a model bill should contain a requirement that policy language must be measured by a readability test. It was observed that a number of readability tests have been developed over the years. These tests differ in some respects, but they are similar in that they permit the use of an objective quantitative formula, usually based upon the length of the words and sentences used. It is generally recognized that these tests all have limitations in that they only measure the difficulty of the style of writing and do not measure understandability.

   Although readability tests are somewhat limited in their usefulness, the use of a widely recognized, easy to apply test has the advantage of providing an objective standard for the benefit of both policy drafters and policy approval personnel. It is one of the few measurements of improved policy "readability" that will give certainty to an otherwise uncertain situation. The Flesch test is best known among the many recognized readability tests, is one of the easiest to apply and is already being used as a standard in a number of states.

   In this light, the task force agreed that in order to achieve uniformity, the Flesch test should be used as the basic standard in the model bill. The use of other recognized tests which are substantially equivalent must also be permitted. The question of the score that should be required was left open for further consideration. But it was pointed out that the Minnesota law requires a score of 40 on the Flesch reading ease test and that other states have also used a score of 40. It was agreed that, although the model bill should set forth a specific score, flexibility must be provided by allowing the Commissioner to accept a lower score in appropriate circumstances.

To assure that the test is uniformly applied, the model bill should set forth the precise rules for applying the test. The task force also concluded that consideration must be given to excluding from the scoring process medical and other technical insurance terms, policy provisions required by law or regulation, or the substance of which is so required.

In order to avoid placing an undue burden on policy approval personnel, it was agreed that each form filed for approval should be accompanied by a certification of the test score achieved by the submitted form. In addition, the Commissioner should be given the right to require the submission of further information to confirm the accuracy of the score certified.

7. The model bill should embody the concept that policy forms which do not include specific language required by any of the laws of the state should be approved if the forms contain provisions not less favorable to the insured, policyowner and beneficiary than those required by such laws.

   The task force noted that although the laws of a number of states presently contain this concept, some companies which have already developed policies with simplified language have encountered difficulty obtaining their approval because the policy language differs from that prescribed by statute. It is, therefore, apparent that this concept should be emphasized.

8. The model bill must provide for realistic time periods for implementing the standards of the bill, and the Insurance Commissioner should be authorized to grant appropriate extensions. Accordingly, the task force recommends that the readability standards apply to new policy forms filed for approval two years after the effective date of the law, and the cutoff date for the use of noncomplying forms approved or deemed approved prior to the effective date of the law should be at least five years from the effective date.

   The task force recognized that changing the entire portfolio of policy forms used by an insurer is a tremendous task, which is both costly and time-consuming. The number of forms that will be filed for approval by all companies is staggering. Sufficient time must be allowed for these forms to be processed by the Insurance Departments. The recommended time periods will permit the orderly development and filing by companies of policies conforming to the standards contained in the law. These time periods will also avoid the imposition of undue burdens on Insurance Department policy approval personnel. Regardless of the time period specified, it would be wise to authorize the Commissioner to extend the compliance date whenever he finds that additional time is warranted.

The task force also considered the following items not mentioned in the discussions of the principles set forth above.

One of the approaches contained in the 1977 bills which the task force studied was to require the use of simple language policy summaries or outlines of coverage as an alternative to simplifying policy language. After discussion, it was agreed that while such alternatives might be helpful for some lines of coverage, it may be more helpful in the long run for the life insurance consumer if the language of the actual policy is made more readable. The main problem is that any ambiguities resulting from two methods of stating the same thing will be construed against the insurer.

Applications present special problems in the view of space limitations and the use of medical terms. After discussion, the consensus of the task force was that perhaps only the agreement portion of the application should be subject to a readability test or to special readability rules.

The task force discussed whether standards should be developed concerning type style and size. It was agreed extreme type styles should be avoided. It was also agreed it may be best to handle the matter of type size by a general statement to the effect that type should be of sufficient size and clarity to be easily read. It was noted in the discussion that if there were to be minimum type sizes, appropriate exceptions should be made for particular items, including portions if not all of applications, tables and specification pages.

In summary, the task force has taken an in-depth look at life insurance policy language simplification. We have found that there is a great deal of interest among the states in the subject, and that many bills were introduced in 1977 and many more are expected in 1978. In order to avoid the adoption of different standards among the states, quick action must be taken by the NAIC. The task force has set forth the basic principles in this report which we believe should be contained in a model bill. Attached hereto is an "exposure draft" of a model bill for life insurance policy language simplification. The task force urges all Commissioners to read the draft carefully. The task force expects that a model bill can be recommended for adoption at the June 1978 meeting of the NAIC. In the mean time, the "exposure draft" may be considered as an alternative to measures which may be introduced in the 1978 legislative sessions.

Hon. W.H.L. Woodyard III, Chairman, Arkansas; Hon. J. Richard Barnes, Colorado; Hon. Jerry B. Buxton, Missouri; Hon. Dick L. Rottman, Nevada; Hon. Millard Oakley, Tennessee.

*****

Exposure Draft

Proposed NAIC Life Insurance Policy Language Simplification Standards Model Act
December 7, 1977

Section 1. Title.

This Act may be cited as the Life Insurance Policy Language Simplification Act.

Section 2. Purpose.

The purpose of this Act is to establish minimum standards to be attained in the simplification of language used in policies of life insurance issued or delivered in this state to facilitate ease of reading by policyholders.

In establishing these standards it is recognized that certain terminology used in insurance policies is difficult or impossible to restate in simplified language either because there are no suitable alternatives as in the case of necessary medical terminology or other insurance words of art or because of statutory or regulatory requirements. It is not the intention of this Act to preclude the use of such terminology or to penalize life insurance companies for its continued use. Nothing in this Act is intended to cause or result in the assumption of increased risk by insurance companies or to supersede the obligation to comply with the substance of insurance legislation otherwise applicable to life insurance policies.

Section 3. Minimum Policy Language Simplification Standards.

(A) In addition to any other requirements of law, no life insurance policy form, except as stated in section 7, shall be issued or delivered in this state on or after the operative date of this Act as defined in section 8, unless:

(1) The text achieves a minimum score of 40 on the Flesch reading ease test or equivalent score on any other comparable reading ease test;

(2) It is printed, except for schedule pages and tables, in not less than ten point type, one point leaded;

(3) The style, arrangement and overall appearance of the policy give no undue prominence to any portion of the text of the policy and to any endorsements or riders; and

(4) It contains a table of contents or an aphabetical subject index of the principal sections of the policy.

(B) For the purposes of this section, a Flesch reading ease text score shall be measured as hereinafter provided:

(1) For policy forms containing 10,000 words or less ot text, the entire form shall be analyzed. For policy forms containing more than 10,000 words, the readability of two 200-word samples per page may be analyzed in lieu of the entire form. The samples shall be separated by at least 20 printed lines.

(2) (a) (i) The number of words and sentences in the text shall be counted and the total number of words divided by the total number of sentences. The figure obtained shall be multiplied by a factor of 1.015.

(ii) The total number of syllables shall be counted and divided by the total number of words. The figure obtained shall be multiplied by a factor of 84.6

(iii) The sum of the figures computed under (i) and (ii) subtracted from 206.835 equals the Flesch reading ease score for the policy form.

(b) For the purposes of clause (a), the following procedures shall be used.

(i) A contraction, hyphenated word or numbers and letters, when separated by spaces, shall be counted as one word;

(ii) A unit of words ending with a period, semicolon or colon, but excluding headings and captions shall be counted as a sentence; and

(iii) A syllable means a unit of spoken language consisting of one or more letters of a word as divided by an accepted dictionary. Where the dictionary shows two or more equally acceptable pronounciations of a word, the pronounciation containing fewer syllables may be used.

(3) The term "text" as used in this section shall include all printed matter except the name and address of the insurer, name or title of the policy, the brief description if any, captions and subcaptions, schedule pages and tables, and medical terminology.

(C) Any other recognized reading ease test shall be approved by the Commissioner for use as an alternative to the Flesch reading ease test upon a showing that such other test is comparable in function and result to the Flesch reading ease test.

(D) Every policy form filed with the Commissioner under this section shall be accompanied by a certificate signed by an officer of the insurer stating the reading ease score achieved on the test used. The Commissioner may, for the purpose of confirming the accuracy of any Flesch or other reading ease test score certified, require the submission of such further information as may be necessary to verify the certification in question.

Section 4.

Drafting Note: *States the laws of which deem policy forms to be approved after they have been on file for a certain period and have not been disapproved should include Alternate 1. States without deemer provisions should include Alternate 2.*

Alternate 1

Nothing in this Act shall be construed to require the affirmative approval of the Commissioner before issuance of a policy form which has been on file for at least (thirty) days. After a policy form has been on file for at least (thirty) days without having been affirmatively approved by the Commissioner or disapproved by the Commissioner as being in violation of any provision of section 3 of this Act, said form shall be deemed approved for purposes of this Act.

Alternate 2

The provisions of sections (insert policy form filing sections of the Insurance Code) shall apply to all policy forms filed for approval pursuant to this Act.

Section 5.

The Commissioner may authorize a lesser score than the Flesche reading ease score required in section 3(A)(1) whenever, in his sole discretion, he finds that a lower score will provide: (a) either a more accurate reflection of the readability of a policy form; or (b) is warranted by the nature of a particular policy form or a type or class of policy forms.

Section 6.

Any policy form filed pursuant to this Act which meets the requirements of section 3(A) shall be approved for use in this state notwithstanding those provisions of any other laws which specify the content of life insurance policies, provided the approved policy assures to the policyholders and claimants protection no less favorable than they would be entitled to under such other law.

Section 7. Applicability.

(A) This Act shall apply to all policies of life insurance delivered or issued for delivery in this state on or after the effective dates set forth in section 8, but nothing in this Act shall apply to: (a) *(group life insurance policies)*;* (b) any policy which is a security subject to federal jurisdiction or which is required to be filed with an agency or instrumentality of the United States government; or (c) any form used in connection with, as a conversion from, or in exchange for a policy issued or delivered on a form approved or deemed approved prior to the date such forms must be approved under this Act.

***Drafting Note:** *The task force believes that certain types of group insurance should be included within the scope of this Act. The extent of the exemptions for group insurance is still under study.*

(B) No other statute of this state relating to language simplification standards shall apply to life insurance policy forms.

Section 8. Effective Dates.

(A) Except as provided in section 7, this Act applies to all life insurance policy forms filed on or after (insert date two years after passage of Act). No policy form approved (or deemed approved) other than under this Act shall be delivered or issued for delivery in this state on or after (insert date five years after passage of Act) unless approved by the Commissioner (or deemed approved) under this Act.

(B) The Commissioner may at any time extend the dates set forth above to such later date or dates as he may determine in his sole discretion.

Section 9.

If part of this Act is held unconstitutional or invalid, all valid parts that are severable from the invalid or unconstitutional part shall remain in effect in all constitutional and valid applications.

To: (C3) Life Insurance Subcommittee

From: Richard V. Minck, Vice President and Chief Actuary
American Council of Life Insurance
1850 K Street, N.W.
Washington, D. C. 20006
202-862-4160

Date November 16, 1977

Re: NAIC Group Insurance Law

It has now been nearly 20 years since the NAIC adopted a model group life insurance law. Despite a few amendments being adopted in the interval, a thorough review of the model law seems long overdue. A number of states in recent years have simply repealed their version of the model law without enacting a satisfactory statute in its place.

The ALCI has, therefore, developed a new version of the model law. We believe this new edition solves many of the problems that some legislatures have seen in the existing model law. We urge that the NAIC Life Insurance (C3) Subcommittee consider our suggested revision of the model law.

Attached are: (1) a discussion of the current situation and reasons for modernizing the model law; (2) a copy of the model law marked to indicate recommended changes; and (3) a section-by-section explanation of the proposed changes. The proposed changes to the model law are indicated by underlining new material and putting brackets around material that should be deleted.

We hope that the NAIC subcommittee will be able to receive this proposal at its December 1977 meeting for review and action in 1978.

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American Council of Life Insurance

The Modernization of the NAIC Model Group
Life Insurance Definition and Standard Provisions
July 1977

The Group Insurance Committee reviewed the NAIC Model Group Life Insurance Definition and Standard Provisions (II Official NAIC Model Laws, Regulations and Guidelines 420-1 -- 420-6) in light of changes in the marketplace since the NAIC had adopted the Model. As a result of its review, the Group Insurance Committee recommends that the Council seek changes in the NAIC Model Bill and in state laws that will:

(1) Remove the majority of those requirements which are essentially underwriting restrictions and restore underwriting discretion to insurers, as is the case in other lines of business;

(2) Preserve the traditional concept of state of jurisdiction group insurance regulation by minimizing or removing the impetus for issuance of coverage in jurisdictions with no legislative or regulatory authority and extending such coverage into jurisdictions where the coverage could not be written;

(3) Make provisions of the Model Bill more responsive to the legitimate demands of consumer interests that the writing of group life insurance be regulated and restricted only to the extent necessary to protect the insurance-buying public.

In broad general form, the above objectives can be accomplished as follows:

(1) Remove the limits on amounts of group term insurance that may be written on any employee or member from those state laws that still contain such limits;

(2) Retain the limits on the amounts of group term life insurance that may be written on dependents but rephrase it in terms of a proportion (50%) of the amount of coverage on the employee or member;

(3) Remove the minimum participation requirements for groups where employees or members contribute all or part of the premium;

(4) Retain the requirement that a minimum number of lives be covered at the time of issue of employer-employee coverage but reduce it to five lives -- remove the requirement for all other types of eligible groups except associations;

(5) Remove the prohibition against employee-pay-all coverage;

(6) Permit companies to make optional plans of additional coverage available; and

(7) Permit group insurance to be written to cover other groups than those included in the current definitions.

The Group Insurance Committee also recommends the addition of certain new provisions to the model group bill that will provide needed and desirable protections for insured individuals. These new provisions are primarily aimed at groups where there is no employer or union involved.

Lastly, the Group Insurance Committee believes that several changes in the "Standard Provisions" section of the Model Bill may be in order. Some of these would only be clarifications of the existing provisions; others are added to give needed protections where coverage under the group policy is discontinued and to groups not involving employers or unions.

History of Group Life Insurance and its Regulation

The first contract of group term life insurance was written to cover the employees of Montgomery Ward and was delivered in 1912. To offer such coverage, the insurer had to devise a substitute for the underwriting process used in selling individual contracts. The substitution, as embodied in the first group case, involved underwriting concepts that guaranteed a reasonable cross section of risk, avoided disproportionately large amounts, protected against adverse selection and seriously imparied risks and kept the annual per capita cost of insurance at an attractive level.

These innovative techniques proved to be a successful business solution to the insurance need raised by Montgomery Ward. Some five years later, these concepts were embodied in the NAIC Model Group Life Insurance Bill. During the next half-century, it was found that group insurance could be soundly underwritten on many other types of groups by adoption of the approach used in the first group case. Moreover, new forms of insurance (other than yearly renewable term) were being developed and successfully sold. As new forms of coverage were developed and new types of groups were covered, modifications were made to the NAIC Model Bill and to state laws to recognize these changes in practice. The regulatory body of law exemplified by the Model Bill has consistently followed and adopted emerging practices which prove to be in the public interest.

Extension of Coverage to Other Groups

The development of the Morris plan banks provided stimulus to the growth of the small loan business. A major New York bank decided to purchase group insurance covering its debtors in the late 1920's. Since then credit life insurance has grown to be a large and varied block of business.

Other groups bound together by employment sought group life insurance. They were underwritten and eventually embodied in the Model definition. One obvious extension was for labor unions to purchase group insurance covering all their members. Another included all employees of a group of employers who were members of an association of employers in one industry or trade. After the Taft-Hartley Act, collectively bargained plans set up with joint trustees were recognized in the Model Bill. Other trusts were established specifically to administer plans covering the employees of many different employers and become part of the Model Definition.

Nonstandard Groups

Although not recognized in the Model Group Life Definition, there has been an increasing extension of group coverage to members of professional associations, alumni groups, fraternal societies and various miscellaneous organizations. For these more loosely related groups, underwriting techniques have been developed that successfully avoid adverse selection, and effective merchanisms have been found for enrollment, administration and claim processing. But for a variety of reasons, sometimes associated with what was sincerely perceived as the broader needs of the public and the insurance industry, the pattern of law following practice was disrupted. Although liberalizing changes continue to be made in the Model, with respect to amounts and the like, further enlargement of the Definition has stopped since 1957.

Description of Current Problem

The NAIC Model Group Life Insurance Definition has not been adopted in all states and has not been adopted in a uniform manner in all states which have adopted a group life definition. The result is that different groups are permissible groups under the laws of different jurisdictions. While the several states have fairly consistently honored the principle that the law of the state where the policy is issued should govern the validity of the contract in all jurisdictions, the practice of forming associations or trusts in states without group laws or otherwise extending coverage under policies that could not have been written in the state is putting pressure on Commissioners to reexamine the proposition that only the law of the state of delivery of the contract controls. The importance of the principle to large multistate cases is apparent, particularly when union bargaining is involved.

The fact is that today the Model Definition is out of date. It omits types of groups now recognized in a number of jurisdictions, and it contains limitations and restrictions now omitted in many states. These deficiencies of omission and limitation lead to strained choices of situs, to the utilization of mass marketing techniques in substitution for recognized group status and they effectively muddy the distinctions between group and nongroup mass marketed coverage. This latter effect has particularly serious regulatory implications as evidenced by the NAIC's appointment of a Task Force on Mass Marketed and Group Life and Health Insurance, which initially took as part of its mission, to review the legal status of long established association cases falling outside the "Model Bill authorized" two or more employer-type associations. While it quickly developed that the thrust of the Commissioners' concern was more specifically with mass marketed coverage, the cause and effect of the existing tangled legal situation is apparent and requires examination of why the group laws have not continued to reflect developing needs as in the past.

This is certainly not the first examination made of this question. In 1960, it was the subject of an extensive investigation by the so-called Beers Committee, followed by what was known as the "little" Beers Committee, and followed in turn by another committee that sought to reduce the jurisdictional conflicts arising from the variations among state laws. How much of this effort was attributable to keeping peace in the family and how much to a concern about the public interest in light of the state of the art at that point makes interesting discussion. Whatever the conclusions applicable at the time of those studies, the public interest has since found more effective channels of communication, and group insurance business has become an even more significant part of the insurance scene. Consumers are very effectively demanding access to any form of inexpensive group insurance that can be soundly underwritten. It has been demonstrated that many types of groups are not currently sanctioned by the Model Bill can be soundly underwritten.

There is usually considerable difference of opinion between the group insurance and individual insurance viewpoints as to whether the industry should accommodate the various so-called public interest considerations involved in any legislation regulating group insurance, either restrictive or expansive. However, concurrence may be expected on these few very pertinent points:

(1) That a large number of groups not included in the Model Definition are now being covered by group insurance on a sound basis in response to legitimate insurance needs.

(2) As long as the law of any given jurisdiction prohibits the writing of such groups and coverage is extended to persons within that jurisdiction from a jurisdiction in which the coverage is legal, conflicts will arise between regulatory authorities and insurers on one hand and regulatory authorities and consumers on the other.

(3) That unless the resolution of these conflicts is moved by the insurers, any resolution imposed by the regulator or by the consumer is not likely to be favored by those favoring either the group or individual point of view. Regulators tend to favor closing state borders to national groups, an action very likely to provoke and be overridden by national legislation. A recent review indicated that there are 17 states which now have a statutory basis for such action and a growing number of states which are actively exploring their statutes for such authority. The consumerist solution, already implemented in several states, is to eliminate regulatory restrictions entirely. There are seven states which have no statutory provisions for the regulation of group life insurance and a few additional states which have adopted a rather liberal group law.

From both points of view, group and individual, the industry's interest would appear to be best served by resumption of the voluntary easing (enlargement) of restrictive group regulatory legislation in response to the facts of the marketplace and in keeping with the constantly increasing consumer interest in sound insurance at the lowest cost available.

Approaches to Modifying the NAIC Model Bill

Action in this direction can proceed from one or two approaches. The first would be to repeal entirely the existing restrictive body of provisions contained in the Model Definition and replace it with a simplified definition of the kind of insurance that can be provided on the group basis, without limitations to groups of particular character, together with certain provisions intended to protect the buyer and the insured from discrimination and overpricing. By eliminating the group life definitions and substituting therefor certain protections for all group coverages, the insurers are freer to respond to the marketplace but restricted from practices considered detrimental to the consumer. It also places emphasis on the coverage (by retaining improved standard provisions) without restricting the availability. This in its essence is the approach presently found in the Oregon law.

The second approach is to review the Model Definition and remove therefrom any restrictive provisions intended to protect the industry from itself that do not serve the interest of the buyer or the insured and also to enlarge the Definition so as to accommodate additional groups that practice has demonstrated can be soundly underwritten.

The Group Insurance Committee has considered and drafted provisions implementing both approaches.

The Committee, after extensive deliberation, rejected approach one in favor of approach two and recommends this choice to the Council. By rejecting approach one, it recognized that certain states had adopted and could be expected in the future to adopt approach one, and the Committee did not mean to dissuade or disapprove of such developments. Very recently, Colorado adopted a group law very similar to approach one. The adoption of approach two, however, seems more realistic for Council policy and should be supported by affirmative action, whether the present Model Law is in existence in a particular state or not.

The reasons for the Committee's recommendations, although elaborate in their evolution, can be simply stated. Liberalization and enlargement of the Model Bill are in order mainly to preserve the existence of a familiar and operating body of regulation that does serve the public interest but can be improved in this respect. Its virtual abandonment as under approach one is neither necessary to meet the existing situation not desirable in light of the somewhat unpredictable consequences that might ensue. Its liberalization and enlargement as proposed in approach two may be reasonably expected to meet present and foreseeable legislative needs and resumes the historical and proven pattern of embracing only what has been demonstrated to be operable and sound.

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ACLI Draft Proposed Revised Group Life Insurance Definition,
Standard Provisions and Conversion Privilege Model Act

Section 1. Group Life Insurance Definition.

No policy of group life insurance shall be delivered in this state unless it conforms to one of the following descriptions:

(1) A policy issued to an employer, or to the trustees of a fund established by an employer, which employer or trustees shall be deemed the policyholder, to insure employees of the employer for the benefit of persons other than the employer, subject to the following requirements:

(a) The employees eligible for insurance under the policy shall be all of the employees of the employer, or all of any class or classes thereof established for other than insurance purposes [determined by conditions pertaining to their employment]. The policy may provide that the term "employees" shall include the employees of one or more subsidiary corporations, and the employees, individual proprietors, and partners of one or more affiliated corporations, proprietorships or partnerships if the business of the employer and of such affiliated corporations, proprietorships, or partnerships is under common control [through stock ownership or contract]. The policy may provide that the term "employees" shall include the individual proprietor or partners if the employer is an individual proprietorship or partnership. The policy may provide that the term "employees" shall include retired employees and directors of a corporate employer. No director of a corporate employer shall be eligible for insurance under the policy unless such person is otherwise eligible as a bona fide employee of the corporation by performing services other than the usual duties of a director. [No individual proprietor or partner shall be eligible for insurance under the policy unless he is actively engaged in and devotes a substantial part of his time to the conduct of the business of the proprietor or partnership.] A policy issued to insure the employees of a public body may provide that the term "employees" shall include elected or appointed officials.

(b) The premium for the policy shall be paid by the policyholder, either [wholly] from the employer's funds [or funds contributed by him], or [partly from such funds and partly] from funds contributed by the insured employees, or from both. [No policy may be issued on which the entire premium is to be derived from funds contributed by the insured employees. A policy on which part of the premium is to be derived from funds contributed by the insured employees may be placed in force only if at least 75% of the then eligible employees, excluding any as to whom evidence of individual insurability is not satisfactory to the insurer, elect to make the required contributions.] Except as provided in Subsection (c), [A] a policy on which no part of the premium is to be derived from funds contributed by the insured employees must insure all eligible employees[, or all except as any as to whom evidence of individual insurability is not satisfactory to the insurer].

(c) An insurer may exclude or limit the coverage on any person as to whom evidence or individual insurability is not satisfactory to the insurer.

[(c)] (d) The policy must cover at least [10] 5 employees at date of issue.

[(d)] (e) The amounts of insurance under the policy must be based upon one or more plans [some plan] precluding individual selection either by the employees or by the employer or trustees.

(2) A policy issued to a creditor or its parent holding company or to a trustee or trustees or agent designated by two or more creditors, which creditor, holding company, trustee, trustees or agent [who] shall be deemed the policyholder, to insure debtors of the creditor, or creditors subject to the following requirements:

(a) The debtors eligible for insurance under the policy shall be all of the debtors of the creditor or creditors [whose indebtedness is repayable either (i) in installments or (ii) in one sum at the end of a period not in excess of eighteen months from the initial date of debt], or all of any class or classes thereof[, determined by conditions pertaining to the indebtedness or to the purchase giving rise to the indebtedness]. The policy may provide that the term "debtors" shall include (i) borrowers of money or purchasers or lessees of goods, services, property, rights or privileges for which payment is arranged through a credit transaction; (ii) the debtors of one or more subsidiary corporation, and (iii) the debtors of one or more affiliated corporations, proprietorships or partnerships if the business of the policyholder and of such affiliated corporations, proprietorships or partnerships is under common control [through stock ownership, contract, or otherwise. No debtor shall be eligible unless the indebtedness constitutes an irrevocable obligation to repay which is binding upon him during his lifetime, at and from the date the insurance becomes effective upon his life].

(b) The premium for the policy shall be paid by the policyholder, either from the creditor's funds, or from charges collected from the insured debtors, or from both. [A policy on which part or all of the premium is to be derived from the collection from the insured debtors of identifiable charges not required of uninsured debtors shall not include, in the class or classes of debtors eligible for insurance, debtors under obligations outstanding at the date of issue without evidence of individual insurability unless at least 75% of the then eligible debtors elect to pay the required charges.] Except as provided in Subsection (c), [A] a policy on which no part of the premium is to be derived from funds contributed by insured debtors specifically for their insurance [the collection of such identifiable charges] must insure all eligible debtors [or all except any as to whom evidence of individual insurability is not satisfactory to the insurer].

(c) [The policy may be issued only if the group of eligible debtors is then receiving new entrants at the rate of at least 100 persons yearly, or may reasonably be expected to receive at least 100 new entrants during the first policy year, and only if the policy reserves to the insurer the right to require evidence of individual insurability if less than 75% of the new entrants become insured.] An insurer may exclude any debtors as to whom evidence of individual insurability is not satisfactory to the insurer. The policy may include an age limitation. [The policy may exclude from the classes eligible for insurance classes of debtors determined by age.]

(d) [The amount of insurance on the life of any debtor shall at no time exceed the amount owed by him which is repayable in installments to the creditor, or $10,000, whichever is less. Where the indebtedness is repayable in one sum to the creditor, the insurance on the life of any debtor shall in no instance be in effect for a period in excess of eighteen months except that such insurance may be continued for an additional period not exceeding six months in the case of default, extension or recasting of the loan.] The amount of the insurance on the life of any debtor shall at no time exceed the greater of the scheduled or actual amount of [the] unpaid indebtedness to the creditor [or $10,000, whichever is less].

(e) The insurance may [shall] be payable to the creditor or any successor to the right, title and interest of the creditor [policyholder]. Such payment shall reduce or extinguish the unpaid indebtedness of the debtor to the extent of such payment.

(f) Notwithstanding the provisions of the above Subsections, insurance on agricultural credit transaction commitments may be written up to the amount of the loan commitment on a nondecreasing or level term plan. Insurance on educational credit transaction commitments may be written up to the amount of the loan commitment less the amount of any repayments made on the loan.

(3) A policy issued to a labor union, or similar employee organization, which shall be deemed to the policyholder, to insure members of such union or organization for the benefit of persons other than the union or organization or any of its officials, representatives or agents, subject to the following requirements:

(a) The members eligible for insurance under the policy shall be all of the members of the union or organization, or all of any class or classes thereof established for other than insurance purposes [determined by conditions pertaining to their employment, or to membership in the union, or both].

(b) The premium for the policy shall be paid by the policyholder, either [wholly] from funds of the union or organization [the union's funds], or [partly from such funds and partly] from funds contributed by the insured members specifically for their insurance or from both. [No policy may be issued on which the entire premium is to be derived from funds contributed by the insured members specifically for their insurance. A policy on which part of the premium is to be derived from funds contributed by the insured members specifically for their insurance may be placed in force only if at least 75% of the then eligible members, excluding any as to whom evidence of individual insurability is not satisfactory to the insurer, elect to make the required contributions.] Except as provided in Subsection (c), [A] a policy on which no part of the premium is to be derived from funds contributed by the insured members specifically for their insurance must insure all elgiible members[, or all except any as to whom evidence of individual insurability is not satisfactory to the insurer].

(c) An insurer may exclude or limit the coverage on any person as to whom evidence of individual insurability is not satisfactory to the insurer.

[(c) The policy must cover at least 25 members at date of issue.]

(d) The amounts of insurance under the policy must be based upon one or more plans [some plan] precluding individual selection either by members or by the union or similar employee organization.

(4) A policy issued to the trustees of a fund established by two or more employers in the same industry, in related industries, or by one or more labor unions or similar employee organizations, or by one or more employers and one or more labor unions or similar employee organizations, which trustees shall be deemed the policyholder, to insure employees of the employers or members of the unions or organizations for the benefit of persons other than the employers or the unions or organizations, subject to the following requirements:

(a) The persons eligible for insurance shall be all of the employees of the employers or all of the members of the unions or organizations, or all of any class or classes thereof established for other than insurance purposes [determined by conditions pertaining to their employment, or to membership in the unions, or to both]. The policy may provide that the term "employees" shall include retired employees, [and] the individual proprietor or partners if an employer is an individual proprietorship or a partnership, and the directors of a corporate employer. No director of a corporate employer shall be eligible for insurance under the policy unless such person is otherwise eligible as a bona fide employee of the corporation by performing services other than the usual duties of a director. [No individual proprietor or partner shall be eligible for insurance under the policy unless he is actively engaged in and devotes a substantial part of his time to the conduct of the business of the proprietor or partnership.] The policy may provide that the term "employees" shall include the trustees or their employees, or both, if their duties are principally connected with such trusteeship.

(b) The premium for the policy shall be paid by the trustees [wholly] from funds contributed by the employer or employers of the insured persons, or by the union or unions or similar employee organizations, or by both, or from funds contributed by the insured persons or from both the insured persons and the employer or union or similar employee organization. [No policy may be issued on which any part of the premium is to be derived from funds contributed by the insured persons specifically for their insurance.] Except as provided in Subsection (c), [The] a policy on which no part of the premium is to be derived from funds contributed by the insured persons specifically for their insurance must insure all eligible persons[, or all except any as to whom evidence of individual insurability is not satisfactory to the insurer].

(c) An insurer may exclude or limit the coverage on any person as to whom evidence of individual insurability is not satisfactory to the insurer.

[(c) The policy must cover at date of issue at least 100 persons and not less than an average of five persons per employer unit; and if the fund is established by the members of an association of employers the policy may be issued only if (i) either (a) the participating employers constitute at date of issue at least 60% of those employer members whose employees are not already covered for group life insurance or (b) the total number of persons covered at date of issue exceeds 600*; and (ii) the policy shall not require that, if a participating employer discontinues membership in the association, the insurance of his employees shall cease solely by reason of such discontinuance.]

***Drafting Note:** *In its report, the Life Insurance Committee of the NAIC stated that "The proposed change indicated above with respect to the total number of persons covered at date of issue has been suggested for the purpose of facilitating underwriting trustee groups where employees exceed 600 lives. There is no unanimity of opinion with respect to this limitation. It is therefore a subject which will require the consideration of individual states in its application." (1949 Proc. 251)]*

(d) The amounts of insurance under the policy must be based upon one or more plans [some plan] precluding individual selection either by the covered [insured] persons or by the policyholder, employers, [or] unions or organizations.

(5) A policy issued to an association or to the trustees of a fund established, created or maintained for the benefit of members of one or more associations all of whose eligible members have the same profession, trade or occupation, which association or associations shall have at the outset a minimum of 100 persons, a constitution and by-laws, shall have been organized and maintained in good faith for purposes other than that of obtaining insurance and shall have been in active existence for at least two years, subject to the following requirements:

(a) The policy may insure members of such association or associations, employees thereof or employees of members, or one or more of the preceding or all of any class or classes thereof established for other than insurance purposes, for the benefit of persons other than the employees' employer, the association or associations, or any officials, representatives, trustees or agents thereof.

(b) The premium for the policy shall be paid by the policyholder, from funds contributed by the association or associations, or by employer members, or by both, or from funds contributed by the covered persons or from both the covered persons and the association, associations, or employer members. Except as provided in Subsection (c), a policy on which no part of the premium is to be derived from funds contributed by the covered persons specifically for their insurance must insure all eligible persons.

(c) An insurer may exclude or limit the coverage on any person as to whom evidence of individual insurability is not satisfactory to the insurer.

(d) The amounts of insurance under the policy must be based upon one or more plans precluding individual selection either by the covered persons, or by the policyholder, association or associations, employers or trustees.

(6) A policy issued to a credit union or to a trustee or trustees or agent designated by two or more credit unions, which credit union, trustee, trustees or agent shall be deemed the policyholder, to insure members of such credit union or credit unions for the benefit of persons other than the credit union or credit unions, trustee or trustees, or agent or any of their officials, subject to the following requirements:

(a) The members eligible for insurance shall be all of the members of the credit union or credit unions, or all of any class or classes thereof.

(b) The premium for the policy shall be paid by the policyholder, either from the credit union's funds, or from charges collected from the insured members, or from both. Except as provided in Subsection (c), a policy on which no part of the premium is to be derived from charges collected from the covered members specifically for their insurance must insure all eligible members.

(c) An insurer may exclude or limit the coverage on any member as to whom evidence of individual insurability is not satisfactory to the insurer. The policy may include an age limitation.

(d) The amounts of insurance under the policy shall be based upon the shares or other savings in the credit union of the members and such amounts of insurance may be determined according to the members' ages. Where the members of the credit union or credit unions are all employees of one or more related employers the amounts of insurance under the policy can be based upon one or more plans precluding individual selection either by the covered persons, or by the policyholder, employers or trustees.

(7) A policy issued to a group other than those specified in Subsections (1) through (6) of this section, if authorized by the Commissioner, where conditions or circumstances indicate that granting such permission for discretionary group life insurance coverages is in the interest of public policy. The Commissioner may refuse to grant such permission if he finds that the proposed group would be actuarially unsound; not result in economies of acquisition and administration which justify a group rate; present hazards of voluntary adverse selection to a degree not usually present in group insurance; or provide amounts of insurance under the policy on the basis of one or more plans which do not preclude individual selection either by the covered persons or by the policyholder, employers, unions or trustees. The premium for the policy shall be paid by the policyholder, either from the policyholder's funds or from funds contributed by the covered persons, or from both. If the premiums for the policy are paid wholly from funds contributed by the insured persons, contributions of such persons must be reasonable in relation to the benefits provided. An insurer may exclude or limit the coverage on any person as to whom evidence of individual insurability is not satisfactory to the insurer.

Section 2. Dependent Group Life Insurance.

Any group life insurance policy issued under Section 1, other than one insuring the lives of debtors, may be extended to insure the employees or members against loss due to the death of their spouses and dependent or minor children, or any class or classes thereof, established for other than insurance purposes, subject to the following:

(1) The premium for the insurance shall be paid by the policyholder, either from funds contributed by the employer, union, association or other person to whom the policy has been issued, or from funds contributed by the covered persons, or from both. Except as provided in Subsection (2), a policy on which no part of the premium for the dependent's coverage is to be derived from funds contributed by the covered persons must insure all eligible employees of members with respect to their spouses and dependent or minor children, or any class or classes thereof, established for other than insurance purposes.

(2) An insurer may exclude or limit the coverage on any family member as to whom evidence of individual insurability is not satisfactory to the insurer.

(3) The amounts of insurance under the policy must be based upon one or more plans precluding individual selection either by the covered persons or by the policyholder, employers, unions, associations, or trustees but not more than 50% of the amount of insurance for which the employee or member is eligible while actively employed.

[II. No such policy of group life insurance may be issued to an employer, or labor union or to the trustees of a fund established in whole or in part by an employer or a labor union, which provides term insurance on any person which, together with any other term insurance under any group life insurance policy or policies issued to the employer or employers of such person or to a labor union or labor unions of which such person is a member or to the trustees of a fund or funds established in whole or in part by such employer or employers or such labor union or labor unions, exceeds $20,000, unless 150% of the annual compensation of such person from his employer or employers exceeds $20,000, in which event all such term insurance shall not exceed $40,000 or 150% of such annual compensation, whichever is the lesser.]

Section 3. Group Life Insurance Standard Provisions.

No policy of group life insurance shall be delivered 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 persons insured, or at least as favorable to the persons insured and more favorable to the policyholder, provided, however, (a) that provisions (6) to (11) [(10)] inclusive shall not apply to policies insuring the lives of debtors [issued to a creditor to insure debtors of such creditor]; (b) that the standard provisions required for individual life insurance policies shall not apply to group life insurance policies; and (c) that if the group life insurance policy is on a plan of insurance other than the term plan, it shall contain a nonforfeiture provision or provisions which in the opinion of the Commissioner is or are equitable to the insured persons and to the policyholder, but nothing herein shall be construed to require that group life insurance policies contain the same nonforfeiture provisions as are required for individual life insurance policies:

(1) A provision that the policyholder is entitled to a grace period of thirty-one days for the payment of any premium due except the first, during which grace period the death benefit coverage shall continue in force, unless the policyholder shall have given the insurer written notice of discontinuance and in accordance with the terms of the policy. The policy may provide that the policyholder shall be liable to the insurer for the payment of a pro rata premium for the time the policy was in force during such grace period.

(2) A provision that the validity of the policy shall not be contested except for nonpayment of premiums, after it has been in force for two years from its date of issue; and that no statement made by any person insured under the policy relating to his insurability shall be used in contesting the validity of the insurance with respect to which such statement was made after such insurance has been in force to the contest for a period of two years during wuch person's lifetime nor unless it is contained in a written instrument signed by him: provided, however, that no such provision shall preclude the assertion at any time of defenses based upon provisions in the policy which relate to eligibility for coverage.

(3) A provision that a copy of the application, if any, of the policyholder shall be attached to the policy when issued, that all statements made by the policyholder or by the persons insured shall be deemed representations and not warranties, and that no statement made by any person insured shall be used in any contest unless a copy of the instrument containing the statement is or has been furnished to such person or, in the event of death or incapacity of the insured person, to his beneficiary or personal representative.

(4) A provision setting forth the conditions, if any, under which the insurer reserves the right to require a person eligible for insurance to furnish evidence of individual insurability satisfactory to the insurer as a condition to part or all of his coverage.

(5) A provision specifying an equitable adjustment of premiums or of benefits or of both to be made in the event the age of a person insured has been misstated, such provision to contain a clear statement of the method of adjustment to be used.

(6) A provision that any sum becoming due by reason of the death of the person insured shall be payable to the beneficiary designated by the person insured, except that where the policy contains conditions pertaining to family status the beneficiary may be the family member specified by the policy terms, subject to the provisions of the policy in the event there is no designated beneficiary, as to all or any part of such sum, living at the death of the person insured, and subject to any right reserved by the insurer in the policy and set forth in the certificate to pay at its option a part of such sum not exceeding $2,000 [$500] to any person appearing to the insurer to be equitably entitled thereto by reason of having incurred funeral or other expenses incident to the last illness or death of the person insured.

(7) A provision that the insurer will issue to the policyholder for delivery to each person insured an individual certificate setting forth a statement as to the insurance protection to which he is entitled, to whom the insurance benefits are payable, a statement as to any dependent's coverage included in such certificate, and the rights and conditions set forth in (8), (9), [and] (10) and (11) following.

(8) A provision that if the insurance, or any portion of it, on a person covered under the policy or on the dependent of a person covered, ceases because of termination of employment or of membership in the class or classes eligible for coverage under the policy, such person shall be entitled to have issued to him by the insurer, without evidence of insurability, an individual policy of life insurance without disability or other supplementary benefits, provided application for the individual policy shall be made, and the first premium paid to the insurer, within thirty-one days after such termination, and provided further that,

(a) The individual policy shall, at the option of such person, be on any one of the forms, except term insurance, then customarily issued by the insurer at the age and for the amount applied for;

(b) The individual policy shall be in an amount not in excess of the amount of life insurance which ceases because of such termination, less the amount of any life insurance for which such person becomes eligible under the same or any other group policy within thirty-one days after such termination, provided that any amount of insurance which shall have matured on or before the date of such termination as an endowment payable to the person insured, whether in one sum or in installments or in the form of an annuity, shall not, for the purposes of this provision, be included in the amount which is considered to cease because of such termination; and

(c) The premium on the individual policy shall be at the insurer's then customary rate applicable to the form and amount of the individual policy, to the class of risk to which such person then belongs, and to his age attained on the effective date of the individual policy.

Subject to the same conditions set forth above, the conversion privilege shall be available (i) to a surviving dependent, if any, at the death of the employee or member, with respect to the coverage under the group policy which terminates by reason of such death and (ii) to the dependent of the employee or member upon termination of coverage of the dependent, while the employee or member remains insured under the group policy, by reason of the dependent ceasing to be a qualified family member under the group policy.

(9) A provision that if the group policy terminates or is amended so as to terminate the insurance of any class of insured persons, every person insured thereunder at the date of such termination whose insurance terminates, including the insured dependent of a covered person, and who has been so insured for at least five years prior to such termination date shall be entitled to have issued to him by the insurer an individual policy of life insurance, subject to the same conditions and limitations as are provided by (8) above, except that the group policy may provide that the amount of such individual policy shall not exceed the smaller of (a) the amount of the person's life insurance protection ceasing because of the termination or amendment of the group policy, less the amount of any life insurance for which he is or becomes eligible under a group policy issued or reinstated by the same or another insurer within thirty-one days after such termination, and (b) $5,000 [$2,000].

(10) A provision that if a person insured under the group policy, or the insured dependent of a covered person, dies during the period within which he would have been entitled to have an individual policy issued to him in accordance with (8) or (9) above before such an individual policy shall have become effective, the amount of life insurance which he would have been entitled to have issued to him under such individual policy shall be payable as a claim under the group policy, whether or not application for the individual policy or the payment of the first premium therefor has been made.

(11) A provision that an insured may continue coverage during the insured's total disability by timely payment to the policyholder of that portion, if any, of the premium that would have been required from the insured had total disability not occurred. The continuation shall be on a premium paying basis for a period of six months from the date on which the total disability started, but not beyond the earlier of (a) approval by the insurer of continuation of the coverage under any disability provision which the group insurance policy may contain or (b) the discontinuance of the group insurance policy.

[(11)] (12) In the case of a policy insuring the lives of debtors [issued to a creditor to insure debtors of such creditors], a provision that the insurer will furnish to the policyholder for delivery to each debtor insured under the policy a form which will contain a statement that the life of the debtor is insured under the policy and that any death benefit paid thereunder by reason of his death shall be applied to reduce or extinguish the indebtedness.

Section 4. Conversion Privileges.

If any individual insured under a group life insurance policy hereafter delivered in this state becomes entitled under the terms of such policy to have an individual policy of life insurance issued to him without evidence of insurability, subject to making of application and payment of the first premium within the period specified in such policy, and if such individual is not given notice of the existence of such right at least 15 days prior to the expiration date of such period, then in such event the individual shall have an additional period within which to exercise such right, but nothing herein contained shall be construed to continue any insurance beyond the period provided in such policy. This additional period shall expire 15 days next after the individual is given such notice but in no event shall such additional period extend beyond 60 days after the expiration date of the period provided in such policy. Written notice presented to the individual or mailed by the policyholder to the last known address of the individual or mailed by the insurer to the last known address of the individual as furnished by the policyholder shall constitute notice for the purpose of this paragraph.

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Section-by-Section Explanation of ACLI Proposed Changes

Section 1. Group Life Definition

Section 1(1). Under Subsection (a), the phrase "... determined by conditions pertaining to their employment" was replaced by the phrase "... established for other than insurance purposes" in order to allow an employer and the insurer greater flexibility in their determination of the definition of eligibility.

Under Subsection (a), the phrase "... through stock ownership or contract" was removed in order to permit an unrestricted definition of the preceding phrase "... common control."

Under Subsection (a), the eligibility restrictions currently applied to proprietors or partners were removed since this is an underwriting determination which should be under the control of the insurer.

Subsection (a) was expanded to allow the inclusion of employees of public bodies.

Subsection (b) was expanded to permit employee-pay-all coverage since this should be an underwriting determination of the insurer. Consistent with the general recommendations, the minimum participation requirements were also removed.

Subsection (c) specifies the rights of the insurer to use evidence of insurability. These rights were previously available under Subsection (b) but it was felt necessary to place greater emphasis on such availability and make clear that an insurer can exclude or limit the coverage on any person as to whom evidence is insurability is unsatisfactory, regardless of whether the policy is written on a contributory, noncontributory or pay-all basis. In conjunction with this increased emphasis, it should be noted that the Standard Provisions require the insurer to specify those situations under which evidence of insurability will be required.

Subsection (d) reflects the change in the minimum lives requirement from ten lives down to five lives. The Group Committee, after extended discussion, decided to recommend retention of a requirement that there be a minimum number of lives in an employer group before a group life insurance policy can be issued. Existing practice notwithstanding, such a restriction can be justified in order to keep a distinction between group and individual coverage. It is to be noted that smaller groups are now mainly being written by career agents – in fact, some companies now have their small group business being exclusively produced and serviced by their agency forces. Lowering the minimum requirement to five lives might assist in preserving or creating agency sales. Further, many small employers want coverage and are receiving it through multiple employer trusts. Such groups are and can continue to be soundly underwritten.

In Subsection (e), the intent was to permit insurers to make optional plans of coverage available while at the same time restricting the potential abuses associated with supplementary schedules. The use of multiple schedules is a relatively common and generally acceptable method for making supplemental coverage available.

Section 1(2). The expansion of this entire section to include parent holding companies, trustees and/or agents thereof is merely intended to keep the model law as it applies to creditors consistent with organizational changes occurring within the financial world.

Under Subsection (a), the removal of all restrictions relating to the type or duration of indebtedness is consistent with the general intention to remove underwriting restrictions. The removal of the "irrevocable obligation" requirement insofar as it applies at the time the insurance is issued is intended to keep the model law current with a growing volume of financial transactions under which there is no irrevocable commitment required.

Under Subsection (a), the expansion of the definition of debtors to include "lesees" is a desirable change since such financial transactions represent definite insurable commitments.

Subsections (b), (c) and (d) have been modified to exclude restrictions of an underwriting nature.

Subsection (e) was modified to allow for the circumstance whereby a certain indebtedness may be transferred from the originating party to another party or parties.

Subsection (f) expands the model law to include special types of creditor situations such as agricultural credit commitments and educational credit requirements.

Section 1(3). This section was expanded to include employee organizations other than labor unions. Similar to Section (1), restrictions of an underwriting nature were also removed. The minimum lives requirement was completely eliminated.

Section 1(4). This section was expanded to include employers in related industries and employee organizations which establish a trust.

Section 1(5). This section represents an addition to the model law. In developing this section, consideration was given to three alternatives, the most liberal of which would have permitted the underwriting of any type of group that could find a basis for underwriting and administration. The second alternative, while retaining the "identifiable group" concept, was still more liberal than the provision currently included in the New York group law which required that the members of the Association have the same profession, trade or occupation. In order to prevent abuses, requirements of an underwriting nature were inserted which require that the association or fund shall have been in active existence for at least two (2) years and have at the outset a minimum of 100 persons.

Section 1(6). This section adds credit unions as a separate type of eligible group under the model law. It is written consistent with Section (2) with the exception that amounts of insurance must be based upon the shares of savings that each of the members have in the credit union if the members are not all employees of one or more related employers.

Section 1(7). This section is added in order to provide an Insurance Commissioner with the authority to permit the issuance of a group insurance policy to a type of group not specifically authorized under Sections (1) through (6). Such groups would be required to meet criteria generally appropriate to group insurance.

Section 2. Dependent Group Coverage

This section incorporates authorization for the issuance of dependent group life coverage to all eligible groups except those insuring the lives of debtors.

The elimination of any restrictions on the amounts of insurance to be permitted under any group insurance policies is consistent with the general recommendations and with the current trend of the states.

Section 3. Group Standard Provisions

Most of the changes proposed are merely clarifications of existing provisions. Others were added to give needed protections to groups not involving employers or unions. In addition, under Section (6) and (9), the amounts of insurance specified have been substantially increased to reflect more appropriate levels of coverage. Section (8) dealing with conversion privileges expands the availability of such privileges to dependents of deceased employees and dependents whose coverage ceases (while the employee's or member's continues) because they no longer are qualified family members as defined in the group policy. A new Section (11) was added to assure continued protection under the group policy for up to six (6) months for totally disabled employees.

(C) Committee Technical Task Force
on Valuation and Nonforfeiture Value Regulation
to the (C3) Life Insurance Subcommittee

SPECIAL REPORT
November 4, 1977

Concerning Extension of the 1958 CSO Mortality Table
At Ages Under 20 to Accommodate A Six-Year Age Setback for Females

The model valuation and nonforfeiture value legislation adopted by the National Association of Insurance Commissioners at the December 1976 meeting provided for a six-year age setback for females. The technical task force recommends adoption of the modifications to the 1958 Commissioners Standard Ordinary Mortality Table and the 1958 Commissioners Extended Term Mortality Table to provide for the six-year age setback for females at ages under 20. These are described in Attachment A to this report.

John O. Montgomery, Chairman, California; W. Keith Sloan, Arkansas; James Montgomery III, D. C.; Larry Gorski, Illinois; Erma Edwards, Nevada; William A. White, New Jersey; Thomas J. Kelly, New York; Ted Becker, Texas; Bradford S. Gile, Wisconsin.

ATTACHMENT A

From: John H. Cook, Actuary

Date: October 21, 1977

Re: 1958 CSO Six-Year Age Setback

The 1958 CSO Mortality Table with a three-year age setback is a permissible basis, in accordance with the insurance statutes of most states, for valuation and nonforfeiture benefits for policies issued on female risks. The mortality rates for the young ages on a strict application of the "three-year age setback" would present anomalies. Female mortality rates would be higher than male mortality rates at ages ten and under, and there would not be any clearly defined female mortality rates at ages zero, one and two. These anomalies were eliminated by a Female Extension of the 1958 CSO table. This extension, along with a description of its derivation, was published in an article on pages 1060-1069 of Volume XI of the Transactions of the Society of Actuaries.

The objective of the extension was to provide rates for female ages 14 and under that would: (1) grade smoothly into the 1958 CSO Table setback three years at ages 15 and over (i.e. male ages 12 and over); (2) be based on the same general method as that used in the construction of the 1958 CSO Table; and (3) start with the best estimate of female mortality rates that correspond to the experience mortality rates shown in the 1958 CSO Basic Table. A corresponding extension was developed for the 1958 CET Mortality Table.

There is reason now to have available a 1958 CSO Mortality Table with a six-year age setback that can be used for female risks. The same anomalies that existed in a strict application of a three-year age setback also exist in the application of a six-year age setback. Accordingly, a new Female Extension of the 1958 CSO Table has been developed to conform with objectives as follows. The new table was designed to provide rates for female ages 14 and under that would: (1) grade smoothly into the original Female Extension (three-year age setback) of the 1958 CSO Table with an additional three-year age setback at ages 15 and over (i.e. original female ages 12 and over); (2) be based on the same general method as that used in developing the original Female Extension (three-year age setback) of the 1958 CSO Table; and (3) start with the best estimate of female experience mortality rates that correspond to the experience mortality rates shown in the 1958 CSO Basic Table.

A review of the general method that was used in the original Female Extension of the 1958 CSO Table for a three-year setback develops the fact that the loading, added to the basic rates, was three cents a thousand less for female ages than it had been for the 1958 CSO Table itself. This was a reflection of the three-year age setback and recognized that the loading formula at young ages for the 1958 CSO Table increased by one cent per thousand per year of age up to age 38. A six-year age setback of the 1958 CSO Table should reflect a further reduction of three cents per thousand in the loading. At the very young ages there is no basis for a revised estimate of the appropriate female experience mortality rates. A combination of these thoughts leads to the conclusion that the very young age mortality rates for a six-year setback should be the values on the three-year setback table reduced by three cents a thousand.

Table 1 shows the mortality rates by individual age that would result from an additional three cent reduction in the loading factor as well as the rates that would result from an additional three-year age setback. Based on an inspection of Columns 2 and 3, a set of rates was adopted for a six-year age setback as follows. For issue ages 10 and under, the rate is equal to the rate in Column 2. For issue ages 14 and over, the rate is equal to the rate in Column 3. For issue ages between 10 and 14, rates were obtained by straight-line interpolation. The final rates are tabulated in Column 4.

In order to test the set of rates for smoothness, we have tabulated first, second and third differences and show these values in Table 2. Apart from the unavoidable distortion in differences for ages 0 and 1, in no case is the absolute value of a third difference greater than one cent a thousand, and in most cases it is zero.

The table that has been developed in this manner is for use on an age nearest birthday basis. Rates for an age last birthday basis have been developed by assuming a uniform distribution of deaths, over the year of age from x to x + 1 on an age nearest birthday basis, with appropriate rounding. These rates for an age last birthday basis are shown in Table 3.

For use with extended term insurance, an extension of the 1958 CET (setback three years) for females at ages 14 and under had been constructed by adding .75 deaths per thousand to the Female Extension of the 1958 CSO Table. A six-year age setback Female Extension of the 1958 CET Table has been correspondingly developed by adding .75 deaths per thousand to the Female Extension (six-year setback) of the 1958 CSO Table. These rates are shown in Table 4. Also in Table 4 are the rates for a Female Extension six-year setback of the 1958 CET Table on an age last birthday basis. These rates, on an age last birthday basis for the CET Table, were developed in the same manner as the age last birthday rates for the CSO.

TABLE 1
1958 CSO Mortality Table -- 1000 q_x

Age Nearest Birthday	1958 CSO With 3-Year Setback (1)	Column (1) Minus .03 (2)	Column (1) With An Additional 3-Year Setback (3)	1958 CSO With 6-Year Setback (4)
0	6.20	6.17		6.17
1	1.67	1.64		1.64
2	1.41	1.38		1.38
3	1.35	1.32	6.20	1.32
4	1.29	1.26	1.67	1.26
5	1.24	1.21	1.41	1.21
6	1.19	1.16	1.35	1.16
7	1.15	1.12	1.29	1.12
8	1.12	1.09	1.24	1.09
9	1.11	1.08	1.19	1.08
10	1.11	1.08	1.15	1.08
11	1.12	1.09	1.12	1.09
12	1.14	1.11	1.11	1.10
13	1.17	1.14	1.11	1.11
14	1.21	1.18	1.12	1.12
15	1.26	1.23	1.14	1.14
16	1.32	1.29	1.17	1.17
17	1.39	1.36	1.21	1.21
18	1.46	1.43	1.26	1.26
19	1.54	1.51	1.32	1.32
20	1.62	1.59	1.39	1.39

TABLE 2

Age Nearest Birthday	1958 CSO Mortality Table With 6-Year Setback 1000 q_x	Col. (1)	Col. (2)	Col. (3)
0	6.17	−4.53	4.27	−4.07
1	1.64	− .26	.20	− .20
2	1.38	− .06	.00	.01
3	1.32	− .06	.01	− .01
4	1.26	− .05	.00	.01
5	1.21	− .05	.01	.00
6	1.16	− .04	.01	.01
7	1.12	− .03	.02	− .01
8	1.09	− .01	.01	.00
9	1.08	− .00	.01	− .01
10	1.08	.01	.00	.00
11	1.09	.01	.00	.00
12	1.10	.01	.00	.01
13	1.11	.01	.01	.00
14	1.12	.02	.01	.00
15	1.14	.03	.01	.00
16	1.17	.04	.01	.00
17	1.21	.05	.01	.00
18	1.26	.06	.01	
19	1.32	.07		
20	1.39			

TABLE 3
1958 CSO Mortality Table With Six-Year Setback – 1000 q_x

Age	Age Nearest Birthday	Age Last Birthday
0	6.17	3.91
1	1.64	1.51
2	1.38	1.35
3	1.32	1.29
4	1.26	1.23
5	1.21	1.18
6	1.16	1.14
7	1.12	1.11
8	1.09	1.09
9	1.08	1.08
10	1.08	1.08
11	1.09	1.09
12	1.10	1.10
13	1.11	1.12
14	1.12	1.13
15	1.14	1.15
16	1.17	1.19
17	1.21	1.23
18	1.26	1.29
19	1.32	1.35
20	1.39	1.43

TABLE 4
1958 CET Mortality Table With Six-Year Setback – 1000 q_x

Age	Age Nearest Birthday	Age Last Birthday
0	6.92	4.66
1	2.39	2.26
2	2.13	2.10
3	2.07	2.04
4	2.01	1.99
5	1.96	1.94
6	1.91	1.89
7	1.87	1.86
8	1.84	1.84
9	1.83	1.83
10	1.83	1.83
11	1.84	1.85
12	1.85	1.86
13	1.86	1.87
14	1.87	1.88
15	1.89	1.91
16	1.92	1.94
17	1.96	1.98
18	2.01	2.04
19	2.07	2.10
20	2.14	2.17

(C) Committee Technical Task Force
to Review Valuation and Nonforfeiture Value Regulation
to the Life Insurance (C3) Subcommittee

December 1977

This report concerns only the proceedings of the NAIC Technical Task Force to Review Valuation and Nonforfeiture Value Regulation since the June 1977 meeting. A recommendation requiring the decision of the NAIC at the December 1977 meeting was sent in a Special Report dated November 4, 1977 to all members of the NAIC.

Proceedings

This report includes the minutes of two meetings, June 5, 1977 (Attachment A) and October 22, 1977 (Attachment B).

1. Actuarial Guidelines

The task force is drafting actuarial guidelines for inclusion in the NAIC Examiners Handbook. The procedure proposed to ask the NAIC subcommittee with jurisdiction with respect to the guideline under consideration to submit that guideline to the NAIC Examiners Manual Subcommittee for inclusion in that manual.

Attached are discussions and in some cases, exposure drafts for guidelines, some of which may be ready by June 1978 to be considered by the Life Insurance (C3) Subcommittee for submission to the Examination Manual Revision (A2) Subcommittee.

a. Reserve Requirements for Valuation With Respect to Interest Rate Guarantees on Active Life Funds Held Relative to Group Annuity Contracts (Attachment C1). The draft attached still needs work so as to avoid annual revision of the Field Examiners Handbook for the updating of the valuation interest factors. Such factors should be provided in a manner analogous to that now used for the valuation of securities.

b. Minimum Cash Surrender Values for Terminal Loaded Individual Deferred Annuities Attachment (C2). For individual deferred annuities with cash surrender values at maturity the interim cash surrender values will be placed on the cash surrender value at maturity. The guideline provides a more detailed definition.

c. The Valuation of Renewable Term Plans. The task force is considering a draft of a guideline with respect to the valuation of decreasing term insurance. The Texas Insurance Department has effected a directive on this subject (Attachment C3) and the American Council of Life Insurance has submitted a recommendation (Attachment C4) which agrees substantially with the Texas directive.

Yet to be resolved are the definition of the scope of the guideline (or "directive") certain terminology items such as the use of the term "deficiency reserves," restrictions on the use of the unitary method" as defined in the directives and the problem of separate tables for female risks.

d. The Valuation of Policies Whose Valuation Net Premiums Exceed the Actual Gross Premium Collected. Guideline: The method of valuation promulgated by the model legislation adopted by the NAIC in December 1977 for the valuation of life insurance policies whose valuation net premiums exceed the actual gross premiums collected is a change in method of reserve calculation and not a change in reserve standards. For policies so valued the maximum permissible valuation interest rate and the applicable mortality basis specified is that in effect at the date of issue of such policies.

e. The Valuation of Deposit Term Insurance. A guideline is being drafted which embodies certain parts of revisions to be proposed for the NAIC Standard Nonforfeiture Law (Attachment C5).

2. Progress on Revision of the Standard Nonforfeiture Law

Attachment D1 is the most recent draft ot the proposed revision to the Standard Nonforfeiture Law as prepared by the American Council of Life Insurance. It contains several features to which the task force takes exception, the most noticeable of which are:

a. The interest assumptions differ from those promulgated for single premium life insurance in the model legislation adopted by the NAIC in December 1976.

b. Section 6 is not acceptable to the task force.

c. Section 7 contains revisions that need closer scruteny by the task force.

An analysis of the proposed revisions has also been prepared in terms of actuarial formulas by the American Council of Life Insurance (Attachment D2).

Until a new mortality table is available, any significant progress on revising the model nonforfeiture value legislation must be delayed. Only when a new table is available, can the full impact of the change in method of calculating nonforfeiture values be ascertained.

3. Progress on the Construction of a New Mortality Table

The Society of Actuaries Special Committee to Develop a New Mortality Table is expected to have new tables available for consideration by October 1978.

4. Other Matters

a. Changes in Membership of the NAIC Technical Task Force to Review Valuation and Nonforfeiture Value Regulation. Three resignations have been received: J. Ramon Estefania, South Carolina; W. Keith Sloan, Arkansas; Lamar Walker, Utah. The task force will miss the many fine contributions of these members. Hopefully they will continue to keep interested in the proceedings of the task force and will be able to offer comments. At present the task force is comprised of eight active members and three vacant positions.

b. Other Guideline Related Matters. Attachments E1, E2 and E3 refer to guideline related matters. Two guidelines are suggested in these statements which are not mentioned above:

   (1) Classification of forms as life insurance or annuities for the purpose of determining nonforfeiture values.
   (2) The distinction between deferred and immediate annuities.

c. Interest Assumptions for Minimum Statutory Reserve Requirements. The continual problem of updating interest and mortality assumptions in the statutes of the various states is a considerable problem because of the lag in enacting changes. The task force is considering alternatives to the present situation to provide more current assumptions when they are needed 'Attachments F1 and F2 address this problem with respect to the valuation interest assumptions.

d. Other Correspondence. Three letters have been included to record:

   (1) Further comments on the interest assumptions for single premium life insurance (Attachment G1).
   (2) The possibility of an advisory committee to the technical task force which will serve as an information exchange with the insurance agents (Attachment G2).
   (3) The role of that technical advisory to the NAIC task force which has been charged with reviewing the long-range aspects of valuation and nonforfeiture value regulation (Attachment G3).

Recommendations

See Special Report dated November 4, 1977.

John O. Montgomery, Chairman, California; James Montgomery III, District of Columbia; Larry Gorski, Illinois; Erma Edwards, Nevada; William A. White, New Jersey; Thomas J. Kelly, New York; Ted Becker, Texas; Bradford S. Gile, Wisconsin.

ATTACHMENT A

(C) Committee Technical Task Force
to Review Valuation and Nonforfeiture Value Regulation

Minneapolis, Minnesota
June 5, 1977

The NAIC (C) Committee Technical Task Force to Review Valuation and Nonforfeiture Value Regulation met from 9:00 a.m. until 5:00 p.m. on June 5, 1977 in the Duluth "B" Room of the Radisson Hotel Downtown, Minneapolis, Minnesota.

Present at the meeting were: for the NAIC Technical Task Force: John O. Montgomery, Chairman, California; W. Keith Sloan, Arkansas; James R. Montgomery III, District of Columbia; Larry M. Gorski, Illinois; Erma Edwards, Nevada; Thomas J. Kelly, New York; J. Ramon Estefania, South Carolina; Ted Becker, Texas; Bradford S. Gile, Wisconsin.

Representing technical advisory committees to the NAIC Technical Task Force: for the (C1) Accident and Health Technical Advisory Committees: Peter Thexton, Valuation, Health Insurance Association of America; Ernie Frankovich, Nonforfeiture Values, Consultant. For the (C2) Credit Insurance Technical Advisory Committee: Ken Jones, CUNA Mutual; Charles Underwood, Maryland Life. For the (C4) Variable Products Technical Advisory Committee: Jerome Golden, Equitable Life.

Representing the Society of Actuaries Special Committee on Nonforfeiture Value Regulation was Harold B. Leff of Metropolitan Life standing in for Charles Greeley, a member of that special committee.

Representing the Society of Actuaries Special Committee for a New Mortality Table was Paul Ochsner of Guarantee Mutual Life.

Representing thy American Council of Life Insurers were Richard V. Minck and John K. Booth.

Representing the National Association of Insurance Brokers was Robert Peter Jeorsch.

Other persons present at the meeting were: Gregg Carney, Anchor National Life Insurance Company; Charles H. Buell, Capitol Life Insurance Company; William J. White Jr., Connecticut General Life Insurance Company; Mike Medland, CUNA Mutual Life; Richard M. Stenson and Carl R. Ohman, Equitable Life Assurance Society; Ronald K. Kurlee, James B. Milholland and Joseph C. Noback, Milliman and Robertson; David M. Holland, Munich American Reassurance; Blaine Shepherd, Northwestern National Life; Robert M. Chmely, Prudential Insurance Company; Howard Kayton and David M. Sonderford, Security First Group; Albert Pike, Teachers Insurance and Annuity; Ronald Wolf, Tillinghast, Nelson & Warren; J. Stephen Beckman and H. C. Jaros, United Investors Life.

A brief summary of the discussion follows, not in the order of the agenda, but in order by NAIC subcommtitee assignments.

1. Special Report of May 2, 1977 to the (C3) Subcommittee.

This special report had recommended that the valuation interest assumption for group annuities issued prior to the 1972 amendments be changed from 3½% to 5%. The task force voted to withdraw this recommendation but to prepare guidelines for those states which may have enacted such legislation in anticipation of NAIC adoption.

2. Terminal Loaded Deferred Annuity Plans.

These annuity plans provide for a lump sum cash surrender value at maturity which is less than the present value of the annuity benefits available at that time because of a terminal loading formula applying a surrender charge at maturity rather than in the early years of issue.

The NAIC technical task force should prepare a guideline stating that for the purposes of interim cash surrender value calculations, the cash surrender value at maturity will be used provided that such cash surrender value at maturity exceeds the value obtained using the minimum cash surrender value definition used in the statute.

Guidelines promulgated by the NAIC upon adoption of recommendations by the NAIC technical task force are not binding on each of the various states but are presented with the intent of developing a consistent practice among the various states with respect to the determination of policy reserves and nonforfeiture values.

3. Revision of the Standard Nonforfeiture Law.

No further action is possible until a new mortality table is developed.

4. The Valuation of Group Annuity Deposit Administration Funds.

Work is needed to:

a. Draft a model enabling legislation to provide a mechanism for the valuation of group annuity deposit administration funds.

b. Expand the New York Department procedure to a national basis.

c. Determine what changes in the annual statement blank are needed to accommodate the valuation of group annuity deposit funds.

5. Progress on the New Mortality Table.

No action was reported, but there was some discussion of categories and nomenclature of tables, such as:

a. Individual standard underwritten issues includes standard medically examined issues.

b. Individual limiting underwriting includes nonmedical issues.

c. Individual guaranteed issues with very little underwriting, if any, includes industrial and guaranteed issues.

d. Individual substandard underwritten issues.

6a. Valuation of Renewable Term Plans. A guideline should be drafted using the proposed Texas regulation as a model. This proposed regulation uses the "Modern CSO Table" to attained age 70 and grade linearly to the 1958 CSO at attained ages 75 and higher. The "Modern CSO Table" is that table published in Appendix A to the "Report on Actuarial Principles and Practical Problems With Regard to Nonforfeiture Requirements" prepared by the Society of Actuaries Special Committee on Valuation and Nonforfeiture Laws, January 1976.

b. Valuation Reserves and Nonforfeiture Values for Deposit Term Plans. A separate guideline is needed using the currently drafted version of the proposed revisions to the standard nonforfeiture law as a model. A reasonable difference between consecutive cash values of a life insurance policy must be established by such a guideline so that the practice of selecting high cash values at certain durations to enhance results for shoppers guides and other index figures is discouraged. Deposit whole life as well as deposit term plans must be considered.

c. Valuation of Split Life Plans. The guidelines and legislation for renewable term and individual deferred annuities should cover this subject.

d. Substandard Plans and Guaranteed Issues.

    (1) Substandard plans require a series of mortality tables.

    (2) Guaranteed issue may be defined so as to cover industrial as a special category within that block of business. The principal criterion for guaranteed issue is that the small amounts usually issued under such plans do not permit elaborate underwriting.

e. Industrial Insurance. See discussion under (a) above.

7. Indexed and Life Cycle Plans.

The task force should contact James Anderson to review the Toronto discussion of the Society of Actuaries meeting concerning this topic and consider what needs to be done with the nonforfeiture law wording to accommodate these products.

8. Changes in the 1978 Life and Accident and Health Blank.

Because of the rapid growth of the annuity business, it may be necessary to consider annuities as a major line of business for the purpose of allocating investment income and expenses. A distinction between immediate and deferred annuities is also needed.

Investment yields on new investments are needed not only for valuation purposes associated with group annuity deposit administration funds, but also for the purpose of developing industry-wide statistics through the NAIC Data Base so as to develop representative yields on new investments each year. From this a formula should be devised for the automatic adjustment of valuation interest assumptions for minimum reserve requirements on new issues so that the valuation legislation need not specify an interest assumption for the determination of minimum policy reserves on new issues.

9. Guidelines for Valuation of Policies With Gross Premiums Less Than the Valuation Net Premiums.

a. The Texas regulation proposed for renewable term plans (Agenda Item 6(a)) covers part of this topic.

b. Another problem concerns plans with nonlevel premiums (i.e. graded premium, modified whole life, deposit whole life, etc.).

    (1) The uniform percentage rule should apply only where for all ages at issue, the premium structure follows some function of the risk involved.

    (2) An example of a deposit whole life plan deliberately calculated to provide no nonforfeiture values for the first nine years brought forth the necessity of defining in a guideline of the destruction between modified life and term insurance followed by an option to select a permanent plan.

10. Other Topics.

a. American Council of Life Insurance report on interest assumptions for single premium life plans was received (Attachment A1).

b. The task force should review problems associated with deposit riders attached to flexible premium individual deferred annuities.

c. For cash surrender values on life insurance policies which exceed the policy reserves, should reserves be set up for such values as may exist in the future? The task force should establish valuation guidelines.

d. Deposit Funds. Should illustrations involving nonguaranteed interest assumptions be made for periods beyond twenty years? The task force should review this question.

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ATTACHMENT A1

To: (C) Committee Technical Task Force on Valuation and Nonforfeiture Value Regulation

From: Richard V. Minck, Vice President and Chief Actuary
American Council of Life Insurance
1730 Pennsylvania Avenue, N.W.
Washington, D. C. 20006
202-393-1020

Date: June 3, 1977

Re: Position of the ACLI on Proposed Changes in the Standard Valuation and Nonforfeiture Laws

One of the questions raised in this position paper is whether a difference of as great as 1% between the interest rates used to establish minimum reserves and nonforfeiture benefits for single premium life insurance policies and those used to establish minimum reserves and nonforfeiture values for annual premium life insurance policies can be justified. Some light is thrown on that question in the attached memorandum from Robert A. Miller III, Vice President and Corporate Actuary of Aetna Life and Casualty. This memorandum contains some calculations which indicate the relatively small spread between annual yields on funds resulting from single premium policies and those on funds resulting from annual premium policies to be appreciably less than 1% for durations of ten years or longer after issue.

The position paper also refers to the possibility of a sharp discontinuity in interest rates for single premium life insurance policies leading to the possibility of widespread replacement of existing policies.

An idea of what could happen is given by an example using a hypothetical single premium rate and current annual premium rates charged by a major company for nonparticipating insurance. The hypothetical single premium rate was developed by the company using the formula underlying its current single premium rates adjusted to reflect the use of 4½% for reserves and 5½% for cash values.

If that company had in 1957 sold an ordinary life policy with a face amount of $33,000 to a man then age 25, the current cash value of that policy would be $8,415. If the man, who would now be age 45, were to take the cash value and apply it at the hypothetical rate, he could buy a single premium policy with a face amount of $37,438. He could then buy for the annual premium of $564.63 he had been paying for 20 years a new ordinary life policy with a face amount of $21,673. His insurance under the combined new policy would be $59,111 or 179% of the amount under his old policy.

We will be happy to supplement this position paper at your meeting on June 5.

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ACLI POSITION PAPER

The National Association of Insurance Commissioners (NAIC) adopted a series of changes to the Model Standard Valuation and Standard Nonforfeiture Laws at their December 1976 meeting. These changes were designed to bring the laws more into line with current and anticipated future investment returns and to modernize the laws in other respects. The American Council of Life Insurance (Council) fully supports these proposed changes with the exception of the proposal to use higher interest rates to set minimum reserves and minimum nonforfeiture benefits for a single premium life insurance than those used for annual premium life insurance policies.

(In addition, we support a change in the Standard Valuation Law which would permit insurers, subject to approval by state insurance departments, to revalue group annuities purchased prior to the operative dates of the amendments to the Standard Valuation Law adopted by the NAIC in 1972 and subsequently enacted by the states. This proposal is still being considered by the NAIC. (To be used only in the states where we are making the proposal contained in this paragraph.))

A. Summary of NAIC Proposals.

The NAIC proposals taken together constitute a much needed updating of the Standard Valuation and Nonforfeiture Laws. They would accomplish the following results.

(1) For the first time, a standard nonforfeiture law would exist for individual deferred annuities -- a product that has become much more popular in recent years due to higher investment yields permitting more attractive prices;

(2) An age setback of up to six years for women would be incorporated in establishing both minimum reserves and minimum nonforfeiture benefits, as contrasted with the three-year setback in the current law. This change would more accurately reflect current differences in mortality;

(3) The statutory interest rate for setting minimum reserves for group annuities and for individual single premium immediate annuities would be increased from 6% to 7.5%;

(4) The statutory interest rate for setting minimum reserves for annual premium life insurance and for annual premium deferred annuities would be increased from 4% to 4.5%;

(5) The statutory interest rate for setting minimum nonforfeiture benefits for annual premium life insurance would be increased from 4% to 5.5%;

(6) The statutory interest rate for setting minimum reserves for single premium deferred annuities would be increased from 4% to 5.5%; and

(7) The statutory interest rates for setting minimum reserves and minimum nonforfeiture benefits for single premium life insurance would be increased from 4% to 5.5% and to 6.5%, respectively.

It is only this last proposal that the Council disagrees with and urges that interest rates be adopted that are 1% lower than those proposed. Such lower rates would correspond with the rates proposed for annual premium life insurance policies.

B. Reasons for Council Position.

The use of different interest rates to establish minimum reserves and nonforfeiture benefits for single premium life insurance from those used for annual premium life insurance represents a departure from the practice of the preceding 100 years. Reasonable arguments can be made both in defense of such a change and in opposition to such a change. On balance, the arguments in favor of continuing to use a single set of interest rates to define minimum reserves and minimum nonforfeiture benefits outweigh those in favor of the change to two sets of interest rates. Even if the decision were to be made to change to two sets of interest rates, we question whether a difference of 1% between the two sets has been justified or can be justified. We think more work needs to be done before a final decision should be made in this area. Meanwhile, we think it advisable to follow the more conservative approach of continuing to use a single set of interest rates to define minimum reserves and nonforfeiture benefits for all life insurance contracts.

1. Theoretical Considerations.

To determine appropriate interest rates to be used to define minimum reserves and nonforfeiture benefits, attention has to be given to (a) current investment results, (b) anticipate future investment results together with possible deviations, (c) possibilities of asset loss resulting from cash surrenders or policy loans, (d) the need to reinvest funds over the lifetime of the contract, and (e) the potential impact on premium resulting from minimum reserves and nonforfeiture benefits being set at too conservative a level.

Somewhat different margins might be required by different cash flow patterns. Limited payment life insurance policies – of which single premium life is an example – will have a different cash flow pattern from that of an annual premium life insurance policy. Some preliminary work shows that there are similar reinvestment patterns for all forms of individual life insurance policies --whetherannual premium or single premium. Moreover, there is greater potential for asset loss resulting from surrender or policy loans on single premium or limited payment life insurance policies than on annual premium life insurance policies. These factors are offset by the consideration that, in the case of a single premium policy, the entire premium can be invested at current high rates. In contrast, future premiums received under an annual premium policy must be invested at then prevailing rates. Any theoretical differences between interest rates appropriate to minimum reserves and nonforfeiture benefits for annual premium policies and those appropraite for single premium policies seem to be small enough to suggest that a reasonable solution would be to ignore them for practical considerations.

2. Practical Considerations.

The sale of single premium life insurance policies in the United States has always been small. A different valuation and nonforfeiture basis for such a very tiny proportion of the business should not be adopted unless such difference is both amply justified and necessary to permit the proper pricing and sale of such business. We do not believe this to be the case.

The change from 4% to 4.5% for minimum reserves and to 5.5% for minimum cash values will make it possible to price single premium life insurance so that it can be sold on a reasonable basis – whether the contract is participating or nonparticipating. A sharper discontinuity in interest rates could lead some companies to misjudge the appropriate level for premiums and reserves for single premium life insurance with the possible risk of company insolvency. Moreover, the sale of such contracts could result in widespread replacement of existing policies with resulting danger to the solvency of companies not even writing single premium life insurance. Similar concerns have surfaced in Canada among agents, companies and regulators, for somewhat the same reasons. The feared disruption in marketing practices has not, as yet occurred; but all parties are reviewing the situation carefully.

C. Conclusions.

The Council supports the main thrust of the NAIC proposals and feels that they should be enacted as soon as possible. We have been working to secure enactment of these proposals throughout the country. We strongly urge that the treatment of single premium life insurance be kept the same as that for annual premium life insurance. We urge just as strongly that enactment of the package not be delayed during the period required for the business and regulators to reach agreement on this one point.

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To: Richard V. Minck
Vice President and Chief Actuary
American Life Insurance Association

From: Robert A. Miller III
Vice President and Corporate Actuary
Aetna Life & Casualty
151 Farmington Avenue
Hartford, Connecticut 06156

Date: May 25, 1977

At its meeting in December 1976, the NAIC adopted certain proposed amendments to the Standard Valuation and Nonforfeiture Laws for life insurance policies. Among other things, these amendments call for a valuation interest rate of 4½% and an interest rate of 5½% for calculation of nonforfeiture values for annual premium policies. For single premium policies, proposed valuation and nonforfeiture interest rates are 5½% and 6½% respectively.

A question has been raised as to whether the 1% difference in favor of single premium policies is justified. The purpose of this letter is to report on what we found in trying to answer this question.

In our analysis, we used two sets of assumptions for mortality and persistency.

One set was that which we use in pricing our guaranteed cost policies. Our purpose in using this set was to determine what average yields would be realized on funds accumulated at various durations by a block of issues at male age 35 that developed experience in exact conformance with our guaranteed cost pricing assumptions.

The other set assumed that there would be no deaths and no lapses for an otherwise identical block of issues. Our purpose in using this set was to determine how much results were affected by mortality and persistency assumptions and what average yields would be realized on funds accumulated at various durations by persisting policies.

Our results and more information about our mortality, interest, expense and lapse assumptions are set out on the attached sheet.

Average yields for single premium policies are clearly higher at duration 10, but it is also clear that the single premium advantage is nothing like 1%. The single premium advantage has completely disappeared by duration 20 and must have been reduced to inconsequential levels well before that point. There is essentially no difference in yields after duration 20.

We have examined the relative levels of the funds that would be accumulated at various durations for a block of issues if our standard pricing assumptions as to mortality, interest, expense and persistency were realized. We found that these funds at the 20th and later durations are large enough to be given significant weight in determining an appropriate level for valuation and nonforfeiture interest rates.

Tests showed our results would not be much affected insofar as differences in average yield were concerned if substantial portions of the accumulated funds were loaned at either a 6% or 8% rate of interest.

We also ran some tests assuming interest rates dropped from 8.75% to 3.15% in fifteen years. Under these conditions, there was a significantly larger single premium advantage at duration 1-, but here too, the advantage was completely eliminated at duration 20 and later. If we thought any such rapid decline in interest rates was at all likely, we would question the propriety of moving to a valuation rate as high as 4½% at this time.

In fact, on the basis of our tests, we believe a valuation rate of 5½% is too high for any form of permanent life insurance at this time. We also believe there is no basis for any difference in valuation rates for single premium and annual premium business.

Interest Earned on Invested Assets
Single Premium vs Annual Premium Whole Life

Sex:	Male
Issue Age:	35
Face Amount:	$37,000
Mortality:	90% of 1955-60 Basic Select, First 15 Years
	84% of 1955-60 Basic Ultimate, After 15 Years
Persistency:	Single -- 5% Level Annual Withdrawals
	Annual -- 17% Year 1, Grading to 2.5% in Year 6
Expenses:	All Medically-Underwritten Expenses
Federal Income Taxes:	Phase I
New Money Rate:	Regular -- 8.75%, Grading to 5% in Year 35
Investment Rollover:	18 Years

Policy Year	Annual Yield at Policy Year Specified: Standard Mortality and Lapses O.L	S.P.	Zero Mortality and Lapses O.L.	S.P.
10	7.4%	7.8%	7.7%	8.1%
20	6.7	6.5	6.9	6.9
30	5.9	5.8	6.2	6.2
40	5.0	4.9	5.3	5.3

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ATTACHMENT B

(C) Committee Technical Task Force
on Valuation and Nonforfeiture Value Regulation

Boston, Massachusetts
October 22-23, 1977

The NAIC Life, Accident and Health Insurance (C) Committee Technical Task Force on Valuation and Nonforfeiture Value Regulation met on October 22-23, 1977 in the fourth floor conference room of the Boston Regional Office of the Prudential Insurance Company of America.

Present at this meeting were: John O. Montgomery, Chairman, California; W. Keith Sloan, Arkansas; James R. Montgomery III, District of Columbia; Robert J. Callahan and Thomas J. Kelly (Mr. Kelly attended only on October 23), New York; J. Ramon Estefania, South Carolina; Ted Becker, Texas; Bradford S. Gile, Wisconsin.

Members of the task force not attending were: Erma Edwards, Nevada; William White, New Jersey; LaMar Walker, Utah (Mr. Walker announced his resignation in a letter to the Chairman).

Other state insurance department representatives attending were: James H. Hunt, Massachusetts; Eleanor Lewis (as chairperson of the Consumer Advisory Committee), New Jersey; Gloria Jiminez (as a member of the Consumer Advisory Committee), North Carolina.

Representing the Consumer Advisory Committee to the NAIC technical task force were: Eleanor Lewis, PhD, chairperson (liaison member), New Jersey Insurance Department; Daphne Bartlett, FSA (liaison member), Occidental Life Insurance Company of California; Margaret Dahm, retired (U.S. Department of Labor); William DuMouchel, PhD, Mathematics Department, Massachusetts Institute of Technology; Marcia D. Greenberger Esq., Center for Law and Social Policy; Gloria Jiminez Esq. (liaison member), North Carolina Insurance Department; Barbara J. Lautzenheiser, FSA (liaison member), Bankers Life of Nebraska; Alisha Munnell, PhD, Federal Reserve Bank of Boston; Robert A. Sable, National Consumer Law Center.

Members of the Society of Actuaries Special Committee on Nonforfeiture Value Laws present were: Charles Greeley, Metropolitan Life; Tom Eason, Security Mutual of Nebraska; Richard S. Miller, Southwestern Life; William K. Nicol, American National Life (also a member of the Society of Actuaries Committee to Construct a New Mortality Table).

Members of the Accident and Health Insurance Valuation Technical Advisory Committee to the NAIC task force present were: E. Paul Barnhart, Chairman, Consultant; James Olson, Prudential Insurance Company; Peter Thexton, Health Insurance Association of America.

Members of the Credit Insurance Technical Advisory Committee to the NAIC task force present were: William C. Cutlip, Chairman, CUNA Mutual; Harvey Galloway Jr., Nationwide Corporation; Perry Kupferman, Provident Alliance; Andrew Markel, League Life; David Newquist, Occidental Life Insurance Company; Charles Underwood, Maryland Life of Baltimore; G.W. Tolman, American National Insurance Company; Lee Zinzow, Munich American Reassurance Company.

Representing the Variable Product Technical Advisory Committee to the NAIC technical task force was Jerome Golden, Equitable Variable Life.

Representing the American Council of Life Insurance were John K. Booth, Vince Donnelly and Richard Minck.

Representing Teachers Insurance and Annuity Association were Albert Pike, Paul Quinn and Tom Welsh.

Those attending with a special interest in the credit insurance portion of the NAIC task force meeting in addition to members of the Credit Insurance Technical Advisory Committee were: Hugh Alexander, Foremost Life; Charles Bentzin, Bentzin & Associates; James F. Blazek, Maryland Life of Baltimore; R.G. Bucher, Old Republic Life; Jay Jaffe, Jaffe & Associates (under contract with the CCIA); Jim Jerwers, Merit Life Insurance Company; Ken Jones, CUNA Mutual; William P. Ogburn, National Consumer Law Center; James P. Valentine, CCIA; Deborah Williams, Maryland Life of Balitmore.

Other interested persons attending were: Richard Boswell, National Western Life, Texas; Jack Caton, American United Life Insurance Company; John Gardner, Sun Life of Canada; Robert L. Hill, Aetna Life & Casualty; David M. Holland, Munich American Reassurance; Robert Johnson, State Farm Life; Howard Kayton, Security First Group; James Knight, SAFECO Life; Robert A. Miller III, Aetna Life & Casualty; Carl R. Ohman, Equitable Life; Richard M. Stevson, Equitable Life; Ron Wolf, Tillinghast, Nelson & Warren.

The Consumer Advisory Committee is to draft a report to the NAIC technical task force covering:

(1) The reorganization of the Consumer Advisory Committee to consider the consumer's interest in <u>all</u> matters covered by the NAIC technical task force, not just sex discrimination.

(2) A proposal for the reimbursement of Consumer Advisory Committee members for travel expense;

(3) The reasons for including as members of the Consumer Advisory Committee only those with no direct relationship with the insurance industry or with insurance regulation.

Under the items relating to the activities of specific NAIC subcommittee comments of members of the Consumer Advisory Committee are included along with comments recorded by those with other interests.

1. Progression on the Construction of a New Standard Mortality Table.

The Society of Actuaries is constructing mortality tables based on the experience of 15 or 20 of the larger insurance companies during the calendar years of 1970 through 1975 for a 15-year select period. Issues of from at least as far back as 1955 are included. The tables are to be determined separately by sex and on a unisex basis. The margins should recognize to some extent the variations in mortality among the 1800 companies writing life insurance.

It appears that mortality is showing a considerable improvement in the 1970's after remaining at somewhat the same level in the 1960's as it had in the 1950's. There are some estimates of as much as a 20% improvement.

Problems to be considered in constructing new tables including the distinction between medical and nonmedical underwritten issues, between underwritten and limited or no underwritten issues, between ordinary and industrial insurance.

2. The drafting of guidelines for:

a. The Valuation of Group Annuity Deposit Administration Funds. This guideline should be generalized and the table of interest assumptions in the valuation must be updated each year by the NAIC Central Office.

b. Valuation and Nonforfeiture Value Regulation of Individual Deferred Annuities. Two guidelines need to be prepared:

(1) For Terminal Loaded Deferred Annuity Contracts. A view was expressed that the model legislation should be reworded to express the intent of the technical task force. Another view stated that any rewording should wait until more significant changes in the laws could be recommended at the same time, but that a guideline should be developed to express the intent of the task force until such time.

Mr. Howard Kayton was asked to prepare a draft of such a guideline.

(2) Definition of Annuity. This includes the distinction between annuities and life insurance, and between deferred and immediate annuities.

Brad Giles was given the assignment of drafting a guideline.

c. The Valuation of Renewable Term Plans. This guideline is to be used until the new standard mortality table is adopted as a standard by a regulatory authority.

The draft of the guideline presented by the American Council of Life Insurance requires further work with respect to the "Scope" section and for the "Unitary Method" defined in the guideline. Under the latter topic, it was pointed out that the Unitary Method should not be used when there were negative terminal reserves in early policy years.

The principal discussion, however, centered on the mortality tables to be used with the following points to be considered in the use of new tables with the guidelines.

(1) The use of the six-year age setback for females in conjunction with the "Modern Mortality Table" which in itself was purported to be a unisex table based upon a proportion of about ten males to one female.

(2) The justification of the use of separate tables by sex as compared to the consequences of using a unisex table.

(3) The problem of publishing "stop-gap" tables at various interest assumptions for the purpose of use with the guidelines.

(4) The consequences of a change from the proportion of females to male lives assumed in the construction of a unisex table.

A study is to be conducted of the age setbacks for female lives generated in comparing the male with female tables for the 1971 annuitant's tables.

d. The Valuation of Policies Whose Valuation Net Premiums Exceed the Actual Gross Premium Collected. The wording for the draft of the guidelines to be presented in the December 1977 Report was devised.

e. Deposit Term Insurance. This guideline is with respect to the calculation of the nonforfeiture values for deposit term insurance plans. It was suggested that the forthcoming legislation be anticipated in drafting such a guideline, but some difficulties with this approach was anticipated because of legislation now in effect.

f. Split Life Insurance. A plea was made to exempt split life from the provisions of the standard annuity nonforfeiture law, but the task force members were not convinced by the arguments presented that this should be done.

g. The Valuation of Substandard Insurance. The discussion resulted in a conclusion that, instead of a guideline, perhaps additional instructions with respect to the statement of actuarial opinion in the NAIC annual statement blank should be drafted along with some additional annual statement blank disclosure of the amounts of substandard business segregated by term versus permanent plans. The task force should ask the American Academy of Actuaries for assistance in drafting such instructions.

h. "Life Cycle" and "Indexed Plans." The NAIC task force will let this matter go for a while. It appears that, instead of a guideline, additional instructions for the Statement of Actuarial Opinion may be needed.

3. Revision of the Standard Nonforfeiture Law.

A new draft of the proposed law was discussed and will be attached to the December 1977 Report. Two of the changes in the proposed legislation discussed were the expense allowance based on the equivalent level amount taken over the first ten years of the policy (instead of the entire life of the policy), and the basing of the expense allowance on a nonforfeiture net level premium (instead of on the first-year premium). A request was made to require that any part of the premium not taken into account in applying the uniform percentage rule be specified in the policy. Other suggestions were made to indicate that further work was needed with respect to considering the definition of one minimum reserve standard with rules, guidelines or exceptions for continuous versus curtate function assumptions and age-last-birthdate versus age-nearest-birthdate assumptions.

4. Minimum Surplus.

No discussion was made of this agenda topic.

5. Other Topics.

A new type of policy paying on the second death of two lives was discussed. Under this contract, cash values and reserves are very high after the first death.

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ATTACHMENT C1

Reserve Requirements for Valuation With Respect to Interest Rate Guarantees on Active Life Funds Held Relative to Group Annuity Contracts

As part of the determination of the aggregate minimum group annuity reserves, a computation must be made of minimum reserves for deposit administration group annuity funds with interest rate guarantees including all such funds pertaining to possible purchase of group annuities whether such funds are held in a separate account or in a general account, whether shown as premiums, advance premiums, auxiliary funds, etc., and whether the liability is shown in Exhibit 8 or elsewhere. In making such computation tye procedure and minimum standards described below shall be applicable for valuation giving recognition to the dates deposits were made. Where appropriate and with the approval of the Commissioner, recognition may be given to the extent and time of application of active life funds to purchase annuities, expense assessments against the fund and excess of purchase price over minimum reserves. In no event shall the reserve be less than the transfer value, if any, of the fund. Approximate methods and averages may be employed with the approval of the Commissioner.

To the extent that the application of these valuation procedures and standards would require a company to establish aggregate minimum reserves for group annuities and related funds in excess of reserves which it would otherwise hold if these valuation procedures and standards did not apply, such company shall set up an additional reserve liability whether shown in its general account or in a separate account, whether shown in Exhibit 8 or elsewhere.

For funds received:

(1) Prior to calendar year 1974, follow the procedure used at that time.

(2) In calendar year 1974, follow the procedure used prior to 1974 or the procedure described below, whichever produces lesser reserves.

(3) In calendar year 1975 or later, follow the minimum standards prescribed below:

(a) Contracts having no guaranteed interest rates in excess of 6% on future contributions to be received more than one year subsequent to the valuation date.

The minimum reserve shall be equal to the sum of the minimum reserves for funds attributable to contributions received in each calendar year.

Where V_y = Minimum reserve for funds attributable to contributions received in calendar year y.

$V_y = [C_y \times (1 + i_{gy})^n] / (1 + i_{py})^n$

C_y = Portion of the guaranteed fund attributable to contributions received in calendar year y.

i_{gy} = Interest rate guaranteed under the contract with respect to funds attributable to contributions received in calendar year y.

i_{py} = Lowest of

(1) the net new money rate credited by the company on group annuity funds attributable to contributions received in calendar year y less .005, or

(2) i_{gy}, or

(3) i_{my}, where

i_{my} = (i) for calendar years y + 1 through y + 10 the values shown in the attached table of values of i_{my}.

(ii) for calendar years y + 11 and later, .060.

n = Number of guarantee years, and fractions thereof, remaining as of the December 31 valuation.

(b) Contracts having guaranteed interest rates in excess of 6% on future contributions to be received more than one year subsequent to the valuation date.

The same procedures as set forth under (a) above shall be used except that for funds attributable to contributions received in calendar year 1976 or later the deduction under (1) of i_{py} shall be .01 instead of .005 and i_{my} shall be reduced by .005.

Table of Values of i_{my} With Respect to Funds Attributable
to Contributions Received in Calendar Year Y

Calendar Year y in Which Contributions Were Received	Value of i_{my} for calendar years y + 1 through y + 10 with respect to funds attributable to contributions received in calendar year y									
	y+1	y+2	y+3	y+4	y+5	y+6	y+7	y+8	y+9	y+10
1974	.075	.075	.075	.075	.075	.075	.075	.075	.075	.075
1975	.081	.081	.081	.081	.081	.077	.073	.069	.065	.060
1976	.089	.089	.089	.089	.089	.089	.089	.089	.089	.089
1977										

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ATTACHMENT C2

To: (C) Technical Task Force on Valuation and Nonforfeiture Value Regulation

From: H. Kayton

Date: October 25, 1977

Re: Recommendation on the Standard Nonforfeiture Law for Individual Deferred Annuities (Response to Assignment in Minneapolis Minutes, Appearing Above)

I. Purpose of the Recommendation

To develop a recommended uniform interpretation of the provisions of this statute as they pertain to the determination of cash surrender values.

II. Background

Section 6 of the Model Bill as written does not require that cash surrender benefits be paid; but where they are paid it requires that such cash surrender benefits grade into maturity value using an interest rate not more than one percent higher than the rate specified in the contract for accumulating net considerations. While this method will be suited for contracts having a sales load at issue, it may create a problem for contracts having surrender charges for cash surrenders.

III. Proposed Solution

We recommend that a guideline be included in the Examiner's Handbook as follows:

Interpretation of Minimum Cash Surrender Benefit Under Standard
Nonforfeiture Law for Individual Deferred Annuities

The minimum cash surrender value at maturity shall be at least equal to the accumulation of the net considerations defined in Section 4 at the greater of 3% or the rate specified in the contract for such accumulations. Cash surrender values prior to maturity shall be the greater of (1) the minimum cash surrender value at maturity discounted to the date of payment at 3%, or (2) the contractual cash surrender value at maturity discounted to the date of payment at an interest rate of 1% greater than the interest rate specified in the contract for determining the cash surrender value at maturity.

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ATTACHMENT C3

Texas Insurance Department
Directive Regarding Minimum Reserves
for Certain Forms of Term Life Insurance

Scope.

This directive deals only with term life insurance which the owner has the unilateral right to maintain in force until its stated expiry date, subject only to the payment of required premiums which vary (increasing on a per $1,000 basis) during the term of the policy. A further requirement is that at the beginning of each policy period during which the required premium per $1,000 remains level, the applicable rate per $1,000 must be the same for renewal at an attained age as for a new issue at that age according to the rates in effect at the date of issue. In addition, premium rates are guaranteed for some future renewal periods.

Ten year renewable term, five year renewable term and one year renewable term are titles commonly given to such policies, but this directive concerns itself with the actual coverage and is not controlled by the name given the coverage.

Historical Position.

The Texas State Board of Insurance has interpreted the Standard Valuation Law requirement for minimum policy reserves on one year renewable term policies to be a basic reserve for the current term period of one-half the cost of insurance for the current term period, plus a deficiency reserve, if any. The required deficiency reserve is the present value of any future excesses of the cost of insurance based upon the valuation of any standard over gross premium. This present value ignores any sufficiencies. Requirements for other forms of renewable term are similar.

Current Situation.

Some companies licensed in Texas have not adhered to the above standard, particularly with respect to the deficiency reserve portion. These companies contend that Texas' historical position is not the only proper interpretation of the Standard Valuation Law. In this regard, they have quoted from Walter O. Menge's classic paper, "Commissioners Reserve Valuation Method" written at the time of construction of the Standard Valuation Law. "... the adaptation of the Commissioners reserve valuation method to fit policies for which the gross premium varies from year to year becomes a problem of generalization which, from a purely theoretical viewpoint, has an infinite number of possible solutions, some of which are practical and others of which are impractical." and, "For these reasons it seems desirable not to formulate at this time any fixed rules for the valuation of these unusual types of policies and riders. The second paragraph of Section 4 of the Standard Valuation Law (Article 3.28, Section 5, of the Texas Insurance Code) does not define the method of valuation of such contracts, but requires that the method used, whatever it may be, must be consistent with that employed for uniform premium policies providing uniform insurance benefits, thus leaving open the possibility of a choice of several consistent methods."[1]

Two other approaches to "consistent" reserves have been suggested.

The unitary policy approach considers such policies as variable premium policies to the mandatory expiry date. Under this approach, the valuation net premiums are a uniform percentage of gross premiums with percentage fixed at issue date. If the appropriate deficiency reserves are held, this approach has great appeal. However, the approach is susceptable to manipulation and illogical results. The State Board is willing to accept reserves according to this approach if the company can demonstrate that actual reserves, including deficiency reserves, for all renewable term business valued using this approach are of the same general magnitude as would occur using an approved method.

The other approach is to hold policy reserves for the current period only, including deficiency reserves if appropriate, and treat the guaranteed availability of coverage in future policy periods as an obligation in the nature of guaranteed insurability. This renewability benefit would fall under the reserve requirements of Article 3.28, Section 4, paragraph (7), Texas Insurance Code, as "other special benefits." While not speaking directly to valuation problems in this instance the Hooker Committee Report said:

> The question was raised whether a policy providing term insurance for several years, automatically followed by permanent insurance, should be considered as two separate policies for the purpose of the Act. In the Committee's opinion, the respective portions may be treated separately if the portion providing permanent insurance takes the Company's regular rate at the then attained age. The rated age provision in the law appears to cover this point.

> However, the Committee draws a distinction between policies providing purely term insurance at the company's published rate at the attained age of conversion, and policies providing for an initial premium such that the increased premium at a subsequent duration differs from that for a new policy at the attained age. The latter case obviously constitutes a single policy to which the formula should be applied at the outset.[2]

The second sentence of the above quotation lends support to the approach of separating the term periods.

Minimum Reserve Requirement.

In view of the above, the Texas State Board of Insurance will henceforth require that the minimum policy reserves for term life insurance within the scope of this directive be determined as follows:

(a) A basic policy reserve, and a deficiency reserve, if any, shall be calculated for the current term period only according to the applicable valuation standard; and

(b) An additional reserve for the guaranteed availability of coverage at guaranteed premiums for future policy periods shall be calculated as the present value of the excess of net level test premiums for each future term period over the respective gross premiums. The test premiums and the present values shall both be calculated at 4½% interest and the attached mortality tables.[3] Should a future gross premium exceed the test premium, the excess shall be considered zero and not a negative amount.

These minimum policy reserves apply to all such term life insurance policies currently in force. They apply to policies issued in Texas and elsewhere, and they apply whether or not the insured resides in Texas.

Adequacy of Reserves.

While the Texas State Board is willing to accept the above as meeting "the requirement of the insurance laws of Texas" this does not in any way relieve the certifying actuary of the insurance company from exercising his own best judgment with respect to the appropriate reserves. In particular, the actuary should consider renewable term contracts of this nature when he states his opinion that aggregate reserves "make a good and sufficient provision for all unmatured obligations of the company guaranteed under the terms of its policies and include provision for all actuarial reserves and related items which ought to be established."

1. 35 American Institute of Actuaries, Record 270, 300.

2. 1947 NAIC Proceedings 257.

3. Not attached here. Their technical description: Age near birthday (ANB) rates are the Modern CSO (ANB) OTSA27, p 624) rates through age 70 for both males and females. For ages 75 and up the rates are 1958 CSO (ANB) rates with females set back 6 years. Ages 71 through 74 are interpolated between these rates.

   Age last birthday (ALB) rates for the Modern CSO were obtained by the same process as used to obtain the 1958 CSO (ALB). With two sets of ALB rates the tables were then obtained by the same process as for ANB.

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ATTACHMENT C4

To: (C) Technical Task Force on Valuation and Nonforfeiture Value Regulation

From: John K. Booth, Associate Actuary
American Council of Life Insurance

Date: October 6, 1977

Re: Deficiency Reserves for Renewable Term Insurance

On May 25, 1977, we mailed to you a discussion draft of a proposed recommendation by the American Council of Life Insurance on Deficiency Reserves for Renewable Term Insurance which was intended to provide a uniform interpretation of the deficiency reserve statutes as they apply to renewable term insurance. Included with our recommendation as Attachment 5 was a "Proposed Model Directive Regarding Minimum Reserves for Certain Forms of Term Life Insurance." Since the June meeting of your task force, we have made several changes in the "Proposed Model Directive" pertaining to its scope, the basis for computing test premiums and its applicability to reinsured business.

The Scope section has been amended to make it clear that the directive applies only to term insurance policies without cash values which require premiums per $1000 which generally increase with duration. The word "generally" has been added to take account of the fact that mortality rates, and hence, term insurance rates at the very young ages may remain relatively level or may decrease for some ranges of ages.

As a basis for calculating test premiums, the "Modern CSO" Mortality Table developed by the Society of Actuaries Special Committee on Valuation and Nonforfeiture Value Laws has been substituted for the 1958 CSO Basic Mortality Table. In relation to recent mortality experience, the margins provided by the "Modern CSO" Mortality Table, as opposed to those provided by the 1958 CSO Basic Mortality Table, are more comparable to the margins contained in the 1958 CSO Mortality Table at the time of its adoption. This is illustrated by placing the two tables side by side as in pages 1 and 2 of Attachment 4 of our submission of May 25, 1977. In addition, the definition of an approved reserve method has been amended to make it clear that test premiums for policies issued to females may be calculated on the basis of the female age setback permitted in the Standard Valuation Law.

A new section has been added on Reinsured Business to clarify who holds deficiency or additional reserves in the case of renewable term insurance business which is reinsured. The basic principle affirmed by this new section is that deficiency or additional reserves are transferred to an authorized reinsurer if the reinsurer guarantees future reinsurance premiums which are lower than the net valuation or test premiums.

Enclosed with this letter is a revised "Proposed Model Directive Regarding Minimum Reserves for Certain Forms of Term Life Insurance" which contains the changes mentioned above. As a supplement to Attachment 1 of our submission of May 25, 1977, there are enclosed basic reserves, net premiums, deficiency reserves and total reserves for a competitively priced Annual Renewable Term to Age 96 policy calculated on the following bases:

Basis 5: Using 1958 CSO 3½% for basic reserves and the "Modern CSO" Mortality Table (see Transactions, Society of Actuaries, Vol. XXVII, 1975, p. 624) and 3½% interest for deficiency reserves.

Basis 6: Same as Basis 5, but using 4½% interest for deficiency reserves.

At the June meeting of your task force, you asked for additional test calculations to show the effect on deficiency reserves for renewable term insurance of using either the 1958 CSO Basic Mortality Table or the "Modern CSO" Mortality Table grading from age 70 into the 1958 CSO Mortality Table at ages 75 and over. In order to show the effects of grading into the 1958 CSO Mortality Table, it was necessary to use unrealistically low gross premium rates. Therefore, the enclosed attachment containing Bases R1 through R10 is based on gross premiums which are about 75% of the gross premiums used in Attachment 1 of our May 25 submission. Otherwise, the calculations on Bases R1 through R10 are comparable to those of Attachment 1 and the supplement to it which we have enclosed with this letter.

Adoption of the "Proposed Model Directive" by the NAIC and the various states would ensure that companies set up adequate reserves for future renewable term insurance obligations and at the same time would encourage competition in this market by removing uncertainties as to the applicable valuation requirements. For this reason, we urge that you recommend that the NAIC adopt the "Proposed Model Directive Regarding Minimum Reserves for Certain Forms of Term Life Insurance" at the earliest possible date.

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Draft Proposed Model Directive Regarding Minimum Reserves
for Certain Forms of Term Life Insurance

October 6, 1977

Scope.

This directive deals only with term life insurance without cash values which the owner has the unilateral right to maintain in force until its stated expiry date, subject only to the payment of required premiums which vary (generally increasing on a per $1000 basis) during the term of the policy and under which premium rates are guaranteed to the stated final expiry.

Ten year renewable term, five year renewable term and one year renewable term are titles commonly given to such policies, but this directive concerns itself with the actual coverage provided and is not controlled by the name given the coverage.

Background Information.

Historically, reserves on one year renewable term policies have consisted of a basic reserve for the current term period of one-half the cost of insurence for the current term period, plus a deficiency reserve, if any. The application of the Commissioners reserve valuation method to determine the basic reserves and deficiency reserves for such policies is subject to varying interpretations as noted in Walter O. Menge's paper, "Commissioners Reserve Valuation Method" written at the time of construction of the Standard Valuation Law. ". . . the adaptation of the Commissioners reserve valuation method to fit policies for which the gross premium varies from year to year becomes a problem of generalization which, from a purely theoretical viewpoint, has an infinite number of possible solutions, some of which are practical and others of which are impractical."[1] and, "For these reasons it seems desirable not to formulate at this time any fixed rules for the valuation of these unusual types of policies and riders. The second paragraph of Section 4 of the Standard Valuation Law does not define the method of valuation of such contracts but requires that the method used, whatever it may be, must be consistent with that employed for uniform premium policies providing uniform insurance benefits, thus leaving open the possibility of a choice of several consistent methods."[2]

Acceptable Approaches.

Two approaches to "consistent" reserves are suggested.

The unitary policy approach considers such policies as variable premium policies up to the mandatory expiry date. Under this approach the valuation net premiums are a uniform percentage of gross premiums with the percentage fixed at issue date. If appropriate deficiency reserves are held, this approach has great appeal. However, it is susceptible to manipulation and illogical results. Reserves according to this approach should be acceptable only if the company can demonstrate that actual reserves, including deficiency reserves, for all renewable term business valued using this approach are of the same general magnitude as would occur using an approved method as defined below.

The other approach is to hold policy reserves for the current period only, including deficiency reserves if appropriate, and to establish additional reserves where net premiums, calculated on a basis which reflects current mortality, exceed gross premiums for future term periods. Although not speaking directly to valuation problems in this instance, the Hooker Committee Report said:

> The question was raised whether a policy providing term insurance for several years, automatically followed by permanent insurance, should be considered as two separate policies for the purpose of the Act. In the Committee's opinion, the respective portions may be treated separately if the portion providing permanent insurance takes the Company's regular rate at the then attained age. The rated age provision in the law appears to cover this point. However, the Committee draws a distinction between policies providing purely term insurance followed by permanent insurance at the company's published rate at the attained age of conversion, and policies providing for an initial premium such that the increased premium at a subsequent duration differs from that for a new policy at the attained age. The latter case obviously constitutes a single policy to which the formula should be applied at the outset.[3]

The second sentence of the above quotation lends support to the approach of separating the term periods.

Under this directive, an approved method is any method which produces reserves greater than or equal to the sum of policy reserves, including deficiency reserves, for the current term period calculated on the basis of the applicable mortality and interest standards and reserve method specified in the Standard Valuation Law plus additional reserves calculated according to the following basis applied uniformly to all such policies:

> The present value of the excess of test premiums for future term periods for which renewable gross premiums are guaranteed over the respective gross premiums, such test premiums and present values being calculated on the "Modern CSO" Mortality Table[4] with 4½% interest. For term insurance issued on female risks, such test premiums may be calculated according to the age younger than the actual age of the insured permitted for Ordinary policies under the Standard Valuation Law.

In case a future gross premium exceeds the test premium, the excess shall be considered zero and not a negative amount. This is in accordance with the principle of anticipating no future profits but providing for all future losses.

In the event a company has not in the past established the additional reserves required by this approved method with respect to its term insurance business in force at the time this directive becomes effective, such company may establish additional reserves for such in-force business equal to a percentage of the additional reserves otherwise required by this directive where such percentage is 20% for the first year this directive becomes effective and increases by 20% in each subsequent year to 100% for the fifth and later years years for which this directive is effective.

<u>Reinsured Business.</u>

If reinsurance is assumed under an agreement in which the reinsurer reserves the right to raise premiums to a level at least as great as the net valuation premiums, the reinsurer is not required to establish deficiency reserves or additional reserves and the ceding company is not permitted to take credit for such reserves on the portion of the business which is reinsured.

If a reinsurance agreement guarantees future reinsurance premiums, the reinsurer should establish deficiency reserves and additional reserves as required by this directive for the period for which reinsurance premiums are guaranteed, and the ceding company may take credit for such reserves on the portion of the business which is reinsured to the extent permitted by law.

<u>Adequacy of Reserves.</u>

Although the above alternative is acceptable as meeting the intent of the Standard Valuation Law, this does not in any way relieve the certifying actuary of the insurance company from exercising his own best judgment with respect to the appropriate reserves. In particular, the actuary should consider renewable term contracts of this nature when he states his opinion that aggregate reserves "make a good and sufficient provision for all unmatured obligations of the company guaranteed under the terms of its policies" and "include provision for all actuarial reserves and related statement items which ought to be established."[5]

<u>Effective Date.</u>

This directive shall become effective with respect to all valuations of reserves for term life insurance which are made on or after ____________________.

1. 35 American Institute of Actuaries, 1946 <u>Record</u> 270.
2. <u>Ibid.</u> 300.
3. 1947 <u>NAIC Proceedings</u> 257.
4. Society of Actuaries, 1975 <u>Transactions,</u> Vol. XXVII 624.
5. 1976 Instructions for Completing NAIC Life and Health Annual Statement Blank 1.

Tables

The attached tables show basic reserves, net premiums, deficiency reserves and total reseves for an Annual Renewable Term to Age 96 policy with unrealistically low premium rates. The various tables are intended to show the relative effects of the use of different mortality tables for the calculation of deficiency reserves.

Basis R1 uses 1958 CSO 3½% for basic reserves and 1958 CSO 4½% for deficiency reserves.

Basis R2 uses 1958 CSO 3½% for basic reserves and the Modern CSO 4½% for deficiency reserves.

Basis R3 uses 1958 CSO 3½% for basic reserves and the "Modern CSO grading into 1958 CSO" 4½% for deficiency reserves. The "Modern CSO grading into 1958 CSO" uses the mortality rates of the "Modern CSO" table for ages 0-70 and the mortality rates of the 1958 CSO of ages 75 and over. The mortality rates for ages 71-74 are based on a straight-line interpolation between two tables. The rates used appear in the attached appendix.

Basis R4 uses 1958 CSO 3½% for basic reserves and the 1958 CSO Tasic Table 4½% for deficiency reserves.

Basis R5 uses 1958 CSO 3½% for basic reserves and the "1958 CSO Basic Table grading into 1958 CSO" 4½% for deficiency reserves. The grading is based on the same method as used for Basis R3. The rates used appear in the attached appendix.

Basis R6 is the same as Basis R1, with 3½% for deficiency reserves.

Basis R7 is the same as Basis R2, with 3½% for deficiency reserves.

Basis R8 is the same as Basis R3, with 3½% for deficiency reserves.

Basis R9 is the same as Basis R4, with 3½% for deficiency reserves.

Basis R10 is the same as Basis R5, with 3½% for deficiency reserves.

[Editor's Note: Current versions of the tables are available from the American Council of Life Insurance.]

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ATTACHMENT C5

Excerpts from Proposed Revisions to the NAIC Standard Nonforfeiture Law
for Life Insurance Which Apply to Deposit Term Insurance

October 17, 1977

Section 5c

. . . the adjusted premiums for any policy shall be calculated on an annual basis and shall be such uniform percentage of the respective premiums specified in the policy for each policy year . . . that the present value, at the date of issue of the policy, of all adjusted premiums shall be equal to the sum of (i) the then present value of the future guaranteed benefits provided for by the policy; . . . and (iii) one hundred twenty-five percent of the nonforfeiture net level premium . . .

The nonforfeiture net level premium shall be equal to the present value, at the date of issue of the policy, of the guaranteed benefits provided for by the policy divided by the present value, at the date of issue of the policy, of an annuity of one per annum payable on the date of issue of the policy and on each anniversary of such policy on which a premium falls due.

Section 8

This Act shall not apply to . . . any term policy of uniform amount, which provides no guaranteed nonforfeiture or endowment benefits . . . nor to any term policy of decreasing amount, which provides no guaranteed nonforfeiture or endowment benefits . . . nor to any policy, which provides no guaranteed nonforfeiture or endowment benefits, for which no cash surrender value, if any, or present value of any paid-up nonforfeiture benefit, at the beginning of any policy year . . . exceeds two and one-half percent (2½%) of the amount of insurance at the beginning of the same policy year . . .

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ATTACHMENT D1

To: (C) Technical Task Force on Valuation and Nonforfeiture Value Regulation

From: John K. Booth, Associate Actuary
American Council of Life Insurance

Date: October 6, 1977

Re: New Draft of Proposed Revisions to the NAIC Standard Nonforfeiture Law for Life Insurance

Enclosed, for consideration at your October 22-23 meeting, is a new draft of Proposed Revisions in the NAIC Standard Nonforfeiture Law for Life Insurance which is based on a prior draft sent to you on October 1, 1976 and a March 23, 1977 draft of suggested modifications which was mailed to you on May 12, 1977. The draft also incorporates several changes which were made as a result of suggestions received from some of our member companies.

We hope to have available for your meeting on October 22, an analysis of the new Standard Nonforfeiture Law expressed in terms of actuarial formulas. We believe that the enclosed draft and analysis will be useful in the continuing work toward developing a new Standard Nonforfeiture Law for Life Insurance.

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Draft Proposed Revisions in the NAIC Standard Nonforfeiture Law
(Underlining Indicates Additions, Brackets Indicate Deletions)

[Editor's Note: Sections and subsections which would remain unchanged are not reprinted here. See II Official NAIC Model Laws, Regulations and Guidelines 810-1 -- 810-5 for them.]

1. This Act shall be known as the Standard Nonforfeiture Law.

2. In the case of policies issued on and after the operative date of this Act as defined in section nine [eight], no policy of life insurance, excepted as stated in section eight [seven], shall be delivered or issued for delivery [or delivered] in this state unless it shall contain in substance the following provisions, or corresponding provisions which in the opinion of the Commissioner are at least as favorable to the defaulting or surrendering policyholder:

(a) That, in the event of default in any premium payment, the company will grant, upon proper request not later than sixty days after the due date of the premium in default, a paid-up nonforfeiture benefit on a plan stipulated in the policy, effective as of such due date of such amount [value] as may hereinafter be specified. In lieu of such stipulated paid-up nonforfeiture benefit, the company may substitute, upon proper request not later than sixty days after the due date of the premium in default, an actuarially equivalent alternative paid-up nonforfeiture benefit which provides a greater amount or longer period of death benefits or, if applicable, a greater amount or earlier payment of endowment benefits.

(e) In the case of policies which cause on a basis guaranteed in the policy unscheduled changes in benefits or premiums, or which provide an option for changes in benefits or premiums other than a change to a new policy, a statement of the mortality table, interest rate, and method used in calculating cash surrender values and the paid-up nonforfeiture benefits available under the policy. In the case of all other policies, a [A] statement of the mortality table and interest rate used in calculating the cash surrender values and the paid-up nonforfeiture benefits available under the policy, together with a table showing the cash surrender value, if any, and paid-up nonforfeiture benefit, if any, available under the policy on each policy and anniversary either during the first twenty policy years or during the term of the policy, whichever is shorter, such values and benefits to be calculated upon the assumption that there are no dividends or paid-up additions credited to the policy and that there is no indebtedness to the company on the policy.

3. Any cash surrender value available under the policy in the event of default in a premium payment due on any policy anniversary, whether or not required by section two, shall be an amount not less than the excess, if any, of the present value, on such anniversary, of the future guaranteed benefits which would have been provided for by the policy, including any existing paid-up additions, if there had been no default, over the sum of (a) the then present value of the adjusted premiums as defined in sections five, five-a, [and] five-b and five-c, corresponding to premiums which would have fallen due on and after such anniversary, and (b) the amount of any indebtedness to the company on the policy. Provided, however, that for any policy issued on or after the operative date of section five-c as defined therein, which provides supplemental life insurance or annuity benefits at the option of the insured and for an identifiable additional premium by rider or supplemental policy provision, the cash surrender value referred to in the first sentence of this section shall be an amount not less than the sum of the cash surrender value as defined in such sentence for an otherwise similar policy issued at the same age without such rider or supplemental policy provision and the cash surrender value as defined in such sentence for a policy which provides only the benefits otherwise provided by such rider or supplemental policy provision. Provided, further, that for any family policy issued on or after the operative date of section five-c as defined therein, which defines a primary insured and provides term insurance on the life of the spouse of the primary insured expiring before the spouse's age seventy-one, the cash surrender value referred to in the first sentence of this section shall be an amount not less than the sum of the cash surrender value as defined in such sentence for an otherwise similar policy issued at the same age without such term insurance on the life of the spouse and the cash surrender value as defined in such sentence for a policy which provides only the benefits otherwise provided by such term insurance on the life of the spouse. Any cash surrender value available within thirty days after any policy anniversary under any policy paid-up by completion of all premium payments or any policy continued under any paid-up nonforfeiture benefit, whether or not required by section two, shall be an amount not less than the present value, on such anniversary, of the future guaranteed benefits provided for by the policy, including any existing paid-up additions, decreased by any indebtedness to the company on the policy.

5. This section five shall not apply to policies issued on or after the operative date of section five-c as defined therein. Except as provided in the third paragraph of this section, ...

5-a. This section five-a shall not apply to Ordinary policies issued on or after the operative date of section five-c as defined therein. In the case of Ordinary policies issued on or after the opeartive date of this section five-a as defined herein, ...

5-b. This section five-b shall not apply to Industrial policies issued on or after the operative date of section five-c as defined therein. In the case of Industrial policies issued on or after the operative date of this section five-b as defined herein, ...

5-c. This section shall apply to all policies issued on and after the operative date of this section five-c as defined herein. Except as provided in the sixth paragraph of this section or in section seven, the adjusted premiums for any policy shall be calculated on an annual basis and shall be such uniform percentage of the respective premiums specified in the policy for each policy year, excluding amounts payable as extra premiums to cover impairments or special hazards and also excluding any uniform annual contract charge or policy fee inherent in such premiums, that the present value, at the date of issue of the policy, of all adjusted premiums shall be equal to the sum of (i) the then present value of the future guaranteed benefits provided for by the policy; (ii) one percent of the amount of insurance, if the insurance be uniform in amount, or of the average amount of insurance at the beginning of each of the first ten policy years; and (iii) one hundred twenty-five percent of the nonforfeiture net level premium as hereinafter defined. The date of issue of a policy for the purpose of this section shall be the date as of which the rated age of the insured is determined.

The nonforfeiture net level premium shall be equal to the present value, at the date of issue of the policy, of the guaranteed benefits provided for by the policy divided by the present value, at the date of issue of the policy, of an annuity of one per annum payable on the date of issue of the policy and on each anniversary of such policy on which a premium falls due.

In the case of policies which cause on a basis guaranteed in the policy unscheduled changes in benefits or premiums, or which provide an option for changes in benefits or premiums, or which provide an option for changes in benefits or premiums other than a change to a new policy, the adjusted premiums and present values shall initially be calculated on the assumption that future benefits and premiums do not change from those stipulated at the date of issue of the policy. At the time of any such change in the benefits or premiums the future adjusted premiums, nonforfeiture net level premiums and present values shall be recalculated on the assumption that future benefits and premiums do not change from those stipulated by the policy immediately after the change.

Except as otherwise provided in the sixth paragraph of this section, the recalculated future adjusted premiums for any such policy shall be such uniform percentage of the respective future premiums specified in the policy for each policy year, excluding amounts payable as extra premiums to cover impairments and special hazards, and also excluding any uniform annual contract charge or policy fee inherent in such premiums, that the present value, at the time of change to the newly defined benefits or premiums, of all such future adjusted premiums shall be equal to the excess of the sum of (i) the then present value of the then future guaranteed benefits provided for by the policy and (ii) the additional expense allowance, if any, over the then cash surrender value, if any, or present value of any paid-up nonforfeiture benefit under the policy.

The additional expense allowance, at the time of the change to the newly defined benefits or premiums, shall be the sum of (i) one percent of the excess, if positive, of the average amount of insurance at the beginning of each of the first ten policy years subsequent to the change over the average amount of insurance prior to the change at the beginning of each of the first ten policy years subsequent to the time of the most recent previous change, or, if there has been no previous change, the date of issue of the policy; and (ii) one hundred twenty-five percent of the increase, if positive, in the nonforfeiture net level premium.

The recalculated nonforfeiture net level premium shall be equal to the nonforfeiture net level premium applicable prior to the change increased by the present value of the increase in future guaranteed benefits provided for by the policy divided by the present value of an annuity of one per annum payable on each anniversary of the policy on or subsequent to the change on which a premium falls due.

Notwithstanding any other provision of this selection to the contrary, in the case of a policy issued on a substandard basis which provides reduced graded amounts of insurance so that, in each policy year, such policy has the same tabular mortality cost as an otherwise similar policy issued on the standard basis which provides higher uniform amounts of insurance, adjusted premiums and present values for such substandard policy may be calculated as if it were issued to provide such higher uniform amounts of insurance on the standard basis.

All adjusted premiums and present values referred to in this Act shall for all policies of Ordinary Insurance be calculated on the basis of the Commissioners 19__ Standard Ordinary Mortality Table and all adjusted premiums and present values for all policies of Industrial insurance be calculated on the basis of ________________. For policies of joint life insurance, adjusted premiums and present values may be calculated on the basis of the equivalent equal age as derived from the Commissioners 19__ Table of Uniform Seniority. All calculations shall be made on the basis of a rate of interest of five and one-half percent (5½%) per annum, except that under any paid-up nonforfeiture benefit, including any paid-up dividend additions, any cash surrender value available, whether or not required by section two, shall be calculated on the basis of the mortality table and rate of interest used in determining the amount of such paid-up nonforfeiture benefit and paid-up dividend additions, if any. Provided, however, that a company may calculate the amount of any guaranteed paid-up nonforfeiture benefit including any paid-up additions under the policy on the basis of an interest rate no lower than that specified in the policy for calculating cash surrender values. Provided, further, that in calculating the present value of any paid-up term insurance with accompanying pure endowment, if any, offered as a nonforfeiture benefit, the rates of mortality assumed may be not more than those shown in the Commissioners 19__ Extended Term Insurance Table for policies of Ordinary insurance and not more than ____________________ for policies of Industrial Insurance. Provided further, that for insurance issued on a substandard basis, the calculation of any such adjusted premiums and present values may be based on appropriate modifications of the aforementioned tables.

After the effective date of this section five-c, any company may file with the Commissioner a written notice of its election to comply with the provisions of this section after a specified date before January first, nineteen hundred and ____________, which shall be the operative date of this section for such company, provided, a company may elect a different operative date for Ordinary policies from that elected for Industrial policies. If a company makes no such election, the operative date of this section for such company shall be January first, nineteen hundred and ____________.

6. Notwithstanding any provisions of sections two, three, four, five, five-a, five-b or five-c to the contrary, any kind of life insurance policy not contemplated by said sections may be issued which provides cash surrender values and paid-up nonforfeiture benefits which do not literally comply with said sections provided the following three conditions are met: (i) The cash surrender values and paid-up nonforfeiture benefits provided by such policy must be not less than the minimum values and benefits required for that kind of policy as determined by regulation promulgated by the Commissioner. (ii) The Commissioner must be satisfied that the benefits provided under that kind of policy are substantially as favorable to policyholders and insureds as the minimum benefits otherwise required by sections two, three, four, five-a, five-b or five-c. (iii) The Commissioner must be satisfied that the benefit and premium structure of that kind of policy is not such as to mislead prospective policyholders or insureds. In making a determination under this section with respect to a particular kind of policy, the Commissioner shall take into consideration any opinion or recommendation of any committee or subcommittee of the National Association of Insurance Commissioners having responsibility for any nonforfeiture matters.

7[6]. Any cash surrender value and any paid-up nonforfeiture benefit, available under the policy in the event of a default in a premium payment due at any time other than on the policy anniversary, shall be calculated with allowance for the lapse of time and the payment of fractional premiums beyond the last preceding policy anniversary. All values referred to in sections three, four, five, five-a, [and] five-b and five-c may be calculated upon the assumptions that any death benefit is payable either at the date of death or at the end of the policy year of death, that premiums are paid either annually at the beginning of each policy year or continuously throughout each policy year, that an insured's age is based on either age last birthday or age nearest birthday for ordinary insurance, and that an insured's age is based on either age nearest birthday or age next birthday for industrial insurance. The net value of any paid-up additions, other than paid-up term additions, shall be not less than the amounts [dividends] used to provide such additions. Notwithstanding the provisions of section three, additional benefits payable (a) in the event of death or dismemberment by accident or accidental means, (b) in the event of total and permanent disability, (c) as reversionary annuity or deferred reversionary annuity benefits, (d) as [decreasing] term insurance benefits provided by a rider or supplemental policy provision to which, if issued as a separate policy, this Act would not apply, (e) as term insurance on the life of a child or on the lives of children provided in a policy on the life of a parent of the child, if such term insurance expires before the child's age is twenty-six, is uniform in amount after the child's age is one, and has not become paid-up by reason of the death of a parent of the child, and (f) as other policy benefits additional to life insurance and endowment benefits, and premiums for all such additional benefits, shall be disregarded in ascertaining cash surrender values and nonforfeiture benefits required by this Act, and no such additional benefits shall be required to be included in any paid-up nonforfeiture benefits.

8[7]. This Act shall not apply to any reinsurance, group insurance, pure endowment, annuity or reversionary annuity contract, nor to any term policy of uniform amount, which provides no guaranteed nonforfeiture or endowment benefits, or renewal thereof, of twenty [fifteen] years or less expiring before age seventy-one [sixty-six], for which uniform premiums are payable during the entire term of the policy, nor to any term policy of decreasing amount, which provides no guaranteed nonforfeiture or endowment benefits, on which each adjusted premium, calculated as specified in sections five, five-a, [and] five-b and five-c, is less than the adjusted premium so calculated, on a [such] term policy of uniform amount, or renewal thereof, issued at the same age and for the same initial amount of insurance[,] and for a term of twenty years or less expiring before age seventy-one, nor to any policy, which provides no guaranteed nonforfeiture or endowment benefits, for which no cash surrender value, if any, or present value of any paid-up nonforfeiture benefit, at the beginning of any policy year, calculated as specified in sections three, four, five, five-a, five-b and five-c, exceeds two and one-half percent (2½%) of the amount of insurance at the beginning of the same policy year, nor to any policy which shall be delivered outside this state through an agent or other representative of the company issuing the policy. For purposes of determining the applicability of this Act, the age at expiry for a joint term life insurance policy shall be the age at expiry of the oldest life.

9[8]. After the effective date of this Act, any company may file with the Commissioner a written notice of its election to comply with the provisions of this Act after a specified date before January first, nineteen hundred and forty-eight. After the filing of such notice, then upon such specified date (which shall be the operative date for such company), this Act shall become operative with respect to the policies thereafter issued by such company. If a company makes no such election, the operative date of this Act for such company shall be January first, nineteen hundred and forty-eight.

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Recommended Changes in Standard Nonforfeiture Law

1. Retain adjusted premium method. Reason: it has worked reasonably well. Change Section: none.

2. Base adjusted premium on expense allowances related to nonforfeiture net premium. Reason: to remove circularity and complexity from formula, especially in the case of nonlevel premium policies. Change Section: 5-c.

3. Decrease the per $1000 component and increase the percent of premium component of the excess initial expense allowance. Reason: to reflect changes in relative expense levels. Change Section: 5-c.

4. Effect of inflation on excess initial expense allowance does not appear substantial. Reason: average size policy is increasing. Change Section: no change needed.

5. Base equivalent level amounts on the first ten years under the policy. Reason: initial per $1000 underwriting expenses are most logically related to amounts of insurance in the early years. This formula is less susceptible to manipulation. Change Section: 5-c.

6. Base excess initial expense allowances on levelized net premiums rather than first-year adjusted premium. Reason: to produce identical excess initial expense allowances for policies with identical benefits and identical premium paying periods. Change Section: 5-c.

7. Remove per policy costs from gross premiums in determining nonforfeiture value net premiums. Reason: to avoid requiring slightly different nonforfeiture values for each size policy where premiums are not level by duration. Change Section: 5-c.

8. Base excess initial expense allowance on the automatic track for multi-track policies. Allow for additional initial expense allowance on increase at point of increase. Reason: it would be unfair to force all companies into lowest possible expense posture to control a limited number of abuses. At time of premium increase there are additional sales and underwriting expenses. Change Section: 5-c.

9. Base excess initial expense allowance for life-cycle and open policies on similar approach to that used for multi-track policies with additional allowances on increases. Reason: see 8 above. Change Section: 5-c. Do not use retrospective accumulation of gross premiums. Give broad regulatory freedom to approve completely "open" and undefined policies. Reason: avoids rate regulation and inconsistencies with adjusted premium approach. There is need to allow freedom for experimentation with new products. Change Section: 6.

10. Establish a procedure to facilitate approval of and to promote flexibility of product designs which are not contemplated by the current Standard Nonforfeiture Law. Reason: to permit the development of new product designs which might be beneficial to the public and would otherwise be inhibited by a nonforfeiture law which is designed to fit more traditional products. Change Section: 6.

11. 5½% interest rate for nonforfeiture values. Reason: this is an appropriate interest rate for use in computing nonforfeiture values on all life insurance policies in the current economic climate. Change Section: 5-c.

12. New mortality table is recommended. Reason: life insurance mortality has improved significantly from the experience underlying the 1958 CSO Mortality Table. Change Section: 5-c.

13. Mortality table should include margins. Reason: tendency toward lower premium forms may produce higher mortality in the future; individual company business varies from the average of the study; margins are needed to provide expenses on paid-up insurance benefits. Change Section: no change needed.

14. A six-year age setback would reasonably approximate separate tables for males and females for determining whole life cash values, but separate male and female mortality rates should be developed as part of the new statutory mortality basis. Reason: to more accurately reflect the difference between male and female mortality in nonforfeiture calculations. Change Section: 5-c.

15. Permit other alternatives in determining nonforfeiture values on substandard policies. Reason: there is need to permit other innovative treatment of substandard risks (e.g. graded death benefits). Change Section: 5-c.

16. Policies that never give rise to nonforfeiture values in excess of 2½% of the death benefit at any duration should be exempted. Reason: it is unwieldy and uneconomical to provide trivial nonforfeiture values. Change Section: 8.

17. Extend term insurance exemption from nonforfeiture values to term of 20 years or less expiring before age 71. Reason: reduces nonforfeiture value inconsistencies between exempt term plans and longer duration term plans. Change Section: 8.

18. Term riders should be treated as separate policies under a severability principle. Reason: the present law impedes utilization of supplemental term riders because it unnecessarily complicates nonforfeiture value calculation. Change Section: 3.

19. Treat renewable and convertible term policies as a series of short term policies for nonforfeiture purposes. Decide this on nature of the coverage. Reason: not to take this view is contrary to nature of the coverage and requires cash values on term insurance. Change Section: no change needed.

20. Treat deposit of deposit term and deposit whole life as an integral part of the plan and not as a pure term insurance plan. Reason: to ensure that nonforfeiture values equitably reflect the value of the deposit. Change Section: 5c and 8.

21. Use a single interest rate for statutory minimum cash values. Reason: to eliminate linkage with the valuation and policy cash value interest rates. Change Section: 5-c and 6 of the Standard Valuation Law.

22. Guaranteed paid-up options should be those purchased by cash value on any interest rate at least as high as that specified in the contract for cash values. Reason: to maintain parity between paid-up options before and after lapse but permit companies to offer more liberal paid-up options. Change Section: 5-c.

23. The cash value mortality table should be used for determining guaranteed paid-up values, except that extended terms should employ higher mortality. Reason: extended term mortality is poorer than paid-up mortality. Change Section: 5-c.

24. Specific expense loadings in paid-up option guarantees are not recommended. Reason: since expense allowances for options which may come into effect many years in the future are imprecise, it is more practical to allow for paid expenses through mortality and interest margins. Change Section: no change needed.

25. Substitute purchase bases granting larger than guaranteed amounts should be permitted for nonforfeiture insurance options and paid-up dividend additions. Reason: to allow companies to offer more liberal nonparticipating nonforfeiture insurance options and paid-up dividend additions than those guaranteed in the policy. Change Section: 2(a) and 5-c.

26. Complete exposition of nonforfeiture values in a policy table should not be required for multi-track of "open" plans. Reason: to avoid showing tables of values which will quickly become obsolete and meaningless to the policyholder. Change Section: 2(c).

27. Single premium life minimum cash values should be based on the same interest rate as is used for annual premium policies. Reason: Nonforfeiture values based on a 5½% interest rate enable companies to offer a viable single premium life insurance product. Change Section: 5-c.

28. Deferred annuities should be subject to minimum cash value requirements based on an accumulation of premiums after exclusion. Reason: nonforfeiture values are appropriate during deferred period and the accumulation method is better understood by the public. Change Section: new section must be created enacting the NAIC Standard Nonforfeiture Model Law for Individual Deferred Annuities.

29. Nonforfeiture values should not be required in accident and health insurance with the possible exception of return of premium contracts. Reason: except for return of premium policies, health insurance is like term life insurance in that it generally would produce only trivial nonforfeiture values. Change Section: no change needed.

30. Technical matters needing further consideration are refund of unearned premiums at death, fractional modes, age nearest and last birthday basis, family policies, uniform seniority rule and removal of requirement for complex or confusing policy provisions relating to cash values. Reason: to clarify and simplify calculation of minimum nonforfeiture values. Change Section: 3, 5-c and 7.

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ATTACHMENT D2

Analysis of Proposed Revisions to the Standard Nonforfeiture Law
in Terms of Actuarial Formulas

October 19, 1977

Section 3, Paragraph 1.

Any cash surrender value (CV) available under the policy in the event of default in a premium payment due on any policy anniversary, whether or not required by section 2, shall be an amount such that:

$$_{t}CV \geq A_t - P_t^A \ddot{a}_t - L_t$$

where t is the number of years since issue:

A_t is the net single premium at time t for the future guaranteed benefits including any paid-up additions;

P_t^A is the adjusted premium as defined in sections 5, 5-a, 5-b and 5-c;

$\ddot{a}_t$ is the present value at time t of a life annuity-due of one per annum for the remainder of the premium-paying period;

L_t is the amount of any indebtedness to the company on the policy. ;

Provided, however, that for any policy issued on or after the operative date . . . which provides supplemental life insurance or annuity benefits by rider or supplemental policy provision:

$$_{t}CV^T \geq {}_{t}CV^P + {}_{t}CV^R$$

where $_{t}CV^T$ is the cash surrender value for the combination of the policy and rider:

$_{t}CV^P$ is the cash surrender value, as defined above, for an otherwise similar policy without such rider or supplemental policy provision;

$_{t}CV^R$ is the cash surrender value as defined at the top of this page, for a policy which provides only the benefits otherwise provided by such rider or supplemental policy provision.

. . . Any cash surrender value (CV) available within thirty days after any policy anniversary under any policy paid-up by completion of all premium payments or any policy continued under any paid-up nonforfeiture benefits, whether or not required by section two, shall be an amount such that:

$$_{t}CV \geq A_t - L_t$$

where t is the number of years since issue:

A_t is the net single premium at the policy anniversary at time t for the future guaranteed benefits including any paid-up additions;

L_t is the amount of any indebtedness to the company on the policy.

Section 4.

Any paid-up nonforfeiture benefit available under the policy in the event of default in a premium payment due on any policy anniversary shall be such that:

When the nonforfeiture option is reduced paid-up insurance:

$$R \cdot A_{x+t} \geq CV_t$$

where R is the amount of reduced paid-up insurance:

x is the age at issue;

t is the policy duration in which the default in premium payment occurred;

A_{x+t} is the net single premium at duration t for the future guaranteed benefits for the policy originally issued at age X;

CV_t is the cash surrender value provided for by the policy at time t, or, if none is provided for, that cash surrender value which would have been required by this Act in the absence of the condition that premiums shall have been paid for at least a specified period.

When the nonforfeiture option is extended term insurance:

$$1000 \cdot A^{\;1}_{x+t:\overline{k}|} \geq CV_t$$

where k is the number of years and days of extended term:

x, t and CV_t are defined as above;

$A^{\;1}_{x+t:\overline{k}|}$ is the net single premium at duration t for the guaranteed benefits in effect from duration t to t+k for the policy originally issued at age x.

Section 5, Paragraph 1.

. . . Except as provided in the third paragraph of this section, the adjusted premiums for any policy shall be calculated on an annual basis and shall be such uniform percentage of the respective premiums specified in the policy for each policy year, excluding amounts stated in the policy as extra premiums to cover impairments or special hazards, that:

When the adjusted premiums (P^A) for the policy are level throughout the premium-paying period:

$$P^A \ddot{a} = A + E'$$

Where A is the net single premium at issue for the future guaranteed policy benefits:

$\ddot{a}$ is the present value at issue of a life annuity-due of one per annum for the premium-paying period.

$$E' = .02\,(ELA) + .4\begin{bmatrix} P^A \\ .04(ELA) \end{bmatrix} + .25\begin{bmatrix} P^A \\ P^A_x(ELA) \\ .04(ELA) \end{bmatrix}$$

where x is the age at issue:

P^A_x is the adjusted premium for a whole life policy;

ELA is the equivalent level amount of insurance as hereinafter defined:

[ ] the smallest of the quantities in each bracket is to be used.

When the adjusted premiums for the policy are not level throughout the premium-paying period:

$$\frac{\sum_{t=1}^{n} P_t^A \cdot D_{x+t-1}}{D_x} = A + E'$$

where P_t^A is the adjusted premium for the policy in the t-th policy year defined by the following formula:

$$P_t^A = \frac{G_t}{G^u} \cdot P^A$$

where G_t is the premium specified in the policy for the t-th policy year;

G^u is the ultimate premium specified in the policy (both G_t and G^u exclude amounts stated in the policy as extra premiums to cover impairments or special hazards).

D is the standard commutation function.

x is the age at issue.

n is the premium-paying period.

A is defined above.

$$E' = .02\,(ELA) + .4\begin{bmatrix} P_1^A \\ .04(ELA) \end{bmatrix} + .25\begin{bmatrix} P_1^A \\ P_x^A(ELA) \\ .04(ELA) \end{bmatrix}$$

where x, ELA and P_x^A are defined as above:

[ ] the smallest of the quantities in each bracket is to be used.

The date of issue of a policy for the purpose of this section shall be the date as of which the rated age of the insured is determined.

Section 5, Paragraph 2.

In the case of a policy providing an amount of insurance varying with duration of the policy, the equivalent level amount (ELA) thereof for the purpose of this section shall be defined by the following formula:

$$ELA = \frac{\sum_{t=1}^{n} DB_t \cdot C_{x+t-1}}{\sum_{t=1}^{n} C_{x+t-1}}$$

where DB_t is the death benefit in the t-th policy year:

n is the benefit period;

x is the age at issue;

C is the standard commutation function.

Section 5-c. Paragraph 1.

. . . Except as provided in the sixth paragraph of this section or in section seven, the adjusted premiums for any policy shall be calculated on an annual basis and shall be such uniform percentage of the respective premiums specified in the policy for each policy year, excluding amounts payable as extra premiums to cover impairments or special hazards, and also excluding any uniform annual contract charge or policy fee inherent in such premiums, that:

When the adjusted premiums (P^A) for the policy are level throughout the premium-paying period:

$$P^A \ddot{a} = A + .01\ ELA + 1.25\ L_p$$

where A is the net single premium at issue for the future guaranteed policy benefits:

$\ddot{a}$ is the present value at issue of a life-annuity due of one per annum for the premium-paying period:

$$ELA = \frac{\sum_{t=1}^{10} DB_t}{10}$$

where DB_t is the death benefit at the beginning of policy year t.

L_p is the nonforfeiture net level premium as hereinafter defined.

When the adjusted premiums for the policy are not level throughout the premium-paying period:

$$\frac{\sum_{t=1}^{n} P_t^A \cdot D_{x+t-1}}{D_x} = A + .01\ ELA + 1.25\ L_p$$

where P_t^A is the adjusted premium for the policy in the t-th policy year defined by the following formula:

$$P_t^A = \frac{G_t}{G^u} \cdot P^A$$

where G_t is the premium specified in the policy for the t-th policy year:

G^u is the ultimate premium specified in the policy (both G_t and G^u exclude amounts stated in the policy as extra premiums to cover impairments or special hazards, and also any uniform annual contract charge or policy fee inherent in such premiums).

D is the standard commutation function;

x is the age at issue;

n is the premium-paying period.

A, ELA and L_p are defined as above.

The date of issue of a policy for the purpose of this section shall be the date as of which the rated age of the insured is determined.

Section 5-c, Paragraph 2.

The nonforfeiture net level premium (L_p) shall be defined by the following formula:

$$L_p = \frac{A}{\ddot{a}}$$

where A is the net single premium at issue for the future guaranteed policy benefits:

$\ddot{a}$ is the present value at issue of a life annuity-due of one per annum for the premium-paying period.

Section 5-c, Paragraph 4.

Except as otherwise provided in the sixth paragraph of this section, the recalculated future adjusted premiums for any such policy shall be such uniform percentage of the respective future premiums specified in the policy for each policy year, excluding amounts payable as extra premiums to cover impairments and special hazards, and also excluding any uniform annual contract charge or policy fee inherent in such premiums, that:

$$P_t^A \ddot{a}_t = A_t + E'' - {}_tCV$$

where t is the duration at which the change occurs:

P_t^A is the future adjusted premium as of the date of the current change;

$\ddot{a}_t$ is the value at duration t of a life-annuity due of one per annum for the remainder of the premium-paying period.

A_t is the net single premium at duration t of guaranteed future benefits;

${}_tCV$ is the cash surrender value at duration t, if any, or the present value at duration t of any guaranteed paid-up nonforfeiture benefit under the policy;

E'' is the additional expense allowance as hereinafter defined.

Section 5-c, Paragraph 5.

The additional expense allowance (E'') at the time of change to the newly-defined benefits or premiums, shall be defined by the following formula

$$E'' = .01\,(ELA' - ELA) + 1.25\,(L_p - L_p)$$

where if $ELA' < ELA$, then $ELA' - ELA$ is defined to be zero, and if $L_p' < L_p$' then $L_p' - L_p$ is defined to be zero.

$$ELA' = \frac{\sum_{s=t+1}^{t+10} DBs}{10}$$

where t is the druation at which the change occurs:

DBs is the death benefit at the beginning of policy year s.

ELA is the average amount of insurance calculated as of the most recent previous change, or, if there has been no previous change, the date of issue of the policy;

L_p' is the nonforfeiture net level premium after the change as hereinafter defined;

L_p is the nonforfeiture net level premium calculated after the most recent previous change, or, if there has been no previous change, at the issue date of the policy.

Section 5-c, Paragraph 6.

The recalculated nonforfeiture net level premium shall be calculated in accordance with the following formula:

$$L_p' = L_p + \frac{(A_t' - A_t)}{\ddot{a}_t}$$

where t is the duration at which the change occurs:

A_t is the net single premium at duration t of future guaranteed policy benefits prior to the change;

A_t' is the net single premium at duration t of future guaranteed policy benefits subsequent to the change;

$\ddot{a}_t$ is the value at duration t of a life-annuity due of one per annum for the remainder of the premium-paying period.

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ATTACHMENT E1

To: John O. Montgomery, Chairman
(C) Committee Technical Task Force on Valuation and Nonforfeiture Value Regulation

From: Howard H. Kayton
Vice President and Actuary
Security First Group
1800 Avenue of the Stars
Los Angeles, California 90067

Date: May 12, 1977

This letter has a dual purpose. First I would like to applaud the accomplishments of your task force in producing a much needed NAIC Standard Nonforfeiture Model Law which relates to individual annuities. It is apparent that your efforts are being well received and reflect changes which are greatly needed in order to be responsive in today's business and regulatory needs.

My second purpose is to call your attention to the possible effect of section 6 of the model law as it might apply to certain individual annuity contract forms. Several years ago our company expended a great deal of effort in developing an annuity contract form which would meet the following objectives.

(1) To extend significant interest guarantees for relatively long periods of time to the buyer. This recognizes the higher interest rates currently available and the economies resulting from efficient administration and our attempts to translate these two items to greater benefits to the buyer.

(2) To provide an annuity that would make no sales charges against payment received when used for the intended purpose of providing retirement income. We believe that a company that knows that it will be managing a policyholder's money for a significantly long period of time has the clear obligation not to penalize him (who annuitizes) because other buyers precipitously surrender their policies.

(3) To further encourage buyers to ultimately use a deferred annuity for its retirement income purposes by increasing interest rates for those policyholders.

(4) To permit the acceptance of flexible payments (frequency and amount) to accommodate a wide range of retirement programs (IRA, HR-10 and individual nonqualified purchases).

(5) Accomplishing all of the above objectives would result in a contract form which would produce the highest amount of retirement income that an insurer could reasonably and safely guarantee. The side effect of such a policy would be that it is fully consistent with the legislative intent of all Internal Revenue Service laws and would be insulated from recent discussions that seek to identify fixed annuities as nonexempt securities subject to registration under the federal securities laws (please note that such a conclusion would represent a possible further intrusion of the SEC into traditional state insurance regulation).

Specifically, the individual, flexible payment fixed annuity sold through Security First Group provides a seven year guaranteed interest rate on purchase payments received while that rate is in effect (this interest rate is now 6.75%, compounded annually, for seven years). No charges or deductions are made from purchase payments when received, and 100% of each payment is applied to produce the annuity Value under the contract at the guaranteed interest rate.

Further, no sales charge is made at any time if the policyholder annuitizes, rather than surrenders his annuity for its cash value (where this annuitization occurs after five years from the original payment date, the annuity value is recomputed using 7.25% interest for the first seven years – instead of 6.75% – thus providing "bonus interest" to produce annuity income). There is an underlying schedule of guaranteed interest rates which are applicable to additional payments under the contract. These underlying rates range from 6.75% during the current contract year down to 3% for the life of the contract.

In order to provide these highly competitive guaranteed interest rates and to not produce a financial penalty to those policyholders who utilize the annuity for its intended purpose (to produce annuity income), there is a termination charge upon surrender of the policy. This termination charge is effectively 7%, since the surrender value is defined as 93% of the Annuity Value (total payments improved with interest).

This form of annuity has been continuously marketed by Security First Group since October of 1974, and a single payment for of this contract since August 1973. Other companies have since used similar forms. The public acceptance of this product has been widespread and resounding. Approximately $300,000,000 of purchase payments under this contract form have been received through Security First Group alone.

Your NAIC task force, when drafting the model law for nonforfeiture values, recognized the problems inherent in requiring total actuarial equivalence of the annuity values and the cash surrender values. The solution selected by your task force was to allow the cash surrender values prior to maturity to be less than the actuarial equivalence of the annuity value at that time. But, apparently, to avoid the possible abuses of policy designs that make surrender charges in addition to front-end sales loads as a means of circumventing the minimum values, the task force also required that the cash surrender value "grade into" the maturity value (see section 6 of the model law). That section <u>does not require</u> that a company provide a cash surrender value; <u>nor does it require</u> that cash values be anything in excess of the specified minimums. But, it could be interpreted to require that if a company provides maturity values in excess of the minimums required by the law, then it must also provide cash values that are higher than the minimums.

The effect of this latter interpretation would be to eliminate policies such as the one I have just described, which undeniably has guaranteed cash values considerably in excess of those required by section 4 of the model law (see Table 1, attached), and which is extremely competitive and consumer oriented.

Please note specifically that the guaranteed values on our contract form are <u>considerably</u> higher than those illustrated in Attachment B of your November 4, 1976 letter to your task force (also shown in Table 1).

I do not believe that it was your task force's intention to restrict the design of annuity products to front-end sales charge products. Your task force, and that of the Society of Actuaries, have both been outspoken in their concern over laws that restrict innovation in product design.

Indeed, both the insurance industry and state insurance departments have received significant criticism for our collective failure to accomplish meaningful insurance reform that would permit the insurance-buying public to have available contracts which make substantial guarantees and meet the needs of our modern society.

Accordingly, I strongly urge the members of your task force to adopt guidelines at your June Minneapolis meeting that would permit individual annuity contract forms to make reasonable surrender charges as long as such contracts produced cash values in excess of those required under Section 4 of the Model Nonforfeiture Law.

It is my hope that you would distribute this letter to members of your task force prior to your meeting in Minneapolis so that my suggestions could be fully considered by your group. Thank you very much for your attention and consideration of this request. If you have any further questions, please call me.

Table 1
NAIC Model Nonforfeiture Law for Individual Deferred Annuities
Comparison of Yields with SFG "Accumulator"

10,000 Single Premium

	Minimum Nonforfeiture Values		SFG Guarantee Surrender Values		Minimum Discounted Maturity Values	
	Cash Value	Gross Yield	Surr. Value	Gross Yield	Cash Value	Gross Yield
1	9,200	-8.00%	9,913	-0.87%	9,200	-8.00%
2	9,476	-2.65	10,567	2.80	9,476	-2.65
3	9,761	-0.08	11,265	4.05	9,761	-0.08
4	10,054	.13	12,011	4.69	10,054	.13
5	10,355	.70	12,807	5.07	10,355	.70
6	10,666	1.08	13.656	5.33	10,666	1.08
7	10,986	1.35	14,563	5.52	11,531	2.06
10	12,004	1.84	16,401	5.07	12,971	2.64
15	13,916	2.23	18,937	4.35	15,781	3.09
20	16,132	2.42	21,876	3.99	19,200	3.32
25	18,701	2.54	25,285	3.78	23,360	3.45
30	21,679	2.61	29,235	3.64	28,421	3.54
35	25,132	2.67	33,816	3.54	34,678	3.61
40	29,134	2.71	39,125	3.47	42,070	3.66
Annuity Value (Dur. 40)						
	29,134	2.71	42,070	3.66	42,070	3.66

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ATTACHMENT E2

To: (C) Technical Task Force to Review Valuation and Nonforfeiture Value Regulation

From: Bradford S. Gile, A.S.A.
Office of the Commissioner
State of Wisconsin

Date: August 10, 1977

Re: Classification of Forms as Life Insurance or Annuities

We have constructed separate nonforfeiture laws for life insurance and annuities, but we have never defined what an annuity is. When we construct model regulations to interpret these laws, we will have to address this issue.

States which have already adopted the nonforfeiture law for deferred annuities will probably have to address this issue immediately. The American Life and Casualty Insurance Company has just filed a form which it calls life insurance, but which has the following characteristics:

(1) Premiums are level to age 65.

(2) Death benefits prior to age 65 equal the larger of cash value or premiums paid in.

(3) Cash surrender values are an accumulation of net premiums at 3½% interest less a surrender charge, and net premiums are 25% of gross premium in year one, 90% in years two through ten and 95% in years eleven through attained age 65.

(4) At age 65, the cash value may be used to purchase paid-up life insurance by policyholder election. If this option is not elected, the cash value automatically purchases an immediate annuity.

This form appears to have cash values which meet the minimum values for life insurance but not annuities. The company calls it life insurance and says it meets statutory requirements. I really think it is an annuity and hence illegal in those states which have the nonforfeiture law for deferred annuities. This example is clear cut, but I strongly suspect products will be developed which are much tougher to classify.

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ATTACHMENT E3

To: (C) Technical Task Force to Review Valuation and Nonforfeiture Value Regulation

From: Larry M. Gorski, Associate Life Actuary
Illinois Department of Insurance
Springfield, Illinois 62767

Date: October 19, 1977

Re: Deficiency Reserves

I will not be able to attend the upcoming task force meeting, but I would like to make a few comments relative to the material that you recently sent me.

Concerning the question of interest rate assumption to be used to compute deficiency reserves, I feel that the Standard Valuation Law associates with each point in time a minimum standard of mortality and rate of interest. Hence, when the phrase "minimum standard of mortality and rate of interest" is used in the section of the law that deals with minimum reserves in the event that net premiums exceed gross premiums, one must consider the minimum standards that were in effect at the time of issue of the contract.

With regards to the Draft Recommendation for Revision of NAIC Model Regulation for Individual A & H Valuation, the concept of requiring active life reserves if the contract is based on the level premium principle and the cost of insurance is increasing during the time frame that premiums remain level, regardless of the renewability provision, is sound, but it places an additional burden on the field examiner. The examiner will now have to determine whether a contract is priced on the level premium principle. This problem is magnified in the event the policy and rates are "borrowed" from another company. I think the practical nature, in addition to the theoretical correctness, needs to be reviewed.

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ATTACHMENT E4

To: (C) Technical Task Force to Review Valuation and Nonforfeiture Value Regulation

From: W. Keith Sloan, Life and Health Actuary
Arkansas Insurance Department
Little Rock, Arkansas

Date: November 10, 1977

Re: Distinction Between Deferred and Immediate Annuities

One of our domestic companies has raised a question which indicates a need for a further guideline pertaining to our revision of the standard valuation law. I am sure that none of us thought that there could be any question as to the distinction between an immediate annuity and a deferred annuity, but it appears that in real life such a distinction is possible, and it can make a difference in the valuation.

The situation is that a trustee of a qualified pension or profit sharing plan may purchase an individual annuity for distribution to a retired employee, and he may actually make the purchase as much as two or three months before the employee actually is retired at which time the "distribution" is made. I do not think that any of us had in mind that a deferred period of a fraction of a year purely for the convenience of the parties involved would move this sort of contract into the deferred category but clearly, without a guideline, some examiner is likely to conclude that this sort of situation creates a deferred annuity requiring a higher valuation rate. Accordingly, I would suggest that we include in our proposed guidelines a definition of a deferred annuity as being one in which the first payment is to be made at least six months after the issue date of the policy.

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ATTACHMENT F1

Proposed Basic Principles With Respect to Interest Assumptions for Minimum Statutory Reserve Requirements

Presented at Concurrent Session of the Society of Actuaries
1977 Annual Meeting on Behalf of A. Charles Howell

(The following basic principles assume that assets and liabilities are consistently measured.)

Preamble: Since the Standard Valuation Law was developed in the 1940's, there have been rapid changes both in economic conditions and in the types of products sold by life insurers. Adjustment of the Standard Valuation Law to reflect these changes has been very slow because it has been necessary to amend the valuation laws of each of the fifty states. A dynamic valuation structure would more accurately reflect differing investment risks associated with various kinds of life insurance and annuity products and would respond readily to changes in the economic climate without requiring repeated amendments to the valuation laws. Such a dynamic valuation structure should require life insurers to establish reserves that are adequate to ensure the fulfillment of future obligations with a high degree of probability but are not so excessive as to unnecessarily increase the cost of life insurance and annuity products to the public. Unlike the current statutes which base minimum valuation reserves for existing business on projections of the future made at particular moments in the past, such a dynamid valuation structure would reduce minimum reserve requirements when warranted by actual and projected experience, but would increase minimum reserve requirements when warranted by actual and projected experience, but would increase minimum reserve requirements when future risks appear to be significantly greater. As a basis for developing a dynamic valuation structure, the following principles are proposed.

I. The objective of statutory minimum reserve requirements is to measure in the aggregate the adequacy of an insurance company's reserve to meet its future contractual obligations.

II. For a company as a whole, statutory minimum reserve requirements should be based upon interest assumptions that reflect the yields which the insurance company expects to earn in the future on the funds available to support the business reduced by appropriate margins to provide for adverse contingencies. A single total company interest assumption may be a convenient measure. However, it should be supported by tests of adequacy by product type. Products with similar investment risk characteristics would have similar contingency margin requirements.

III. The minimum reserve requirements: (1) should be prospective in the sense that current statutory valuation assumptions should be applied to each piece of business no matter when written; and (2) should be adjusted gradually and automatically from year to year to reflect changes in the future outlook for interest earnings so as to be adequate but not excessive.

IV. The valuation basis should evaluate obligations according to the investment risks characteristic to the product portfolio. (Tests are needed for each category of products to determine what maximum reserve valuation interest rates are adequate and how they should vary to reflect changing economic conditions.)

A. Reserves should take into account contractual guarantees with respect to future considerations. (The term of such guarantees may range from less than a year to the whole of life.)

B. Reserve valuation assumptions should be divorced from assumptions used in determining withdrawal or nonforfeiture values.

C. Reserves in the aggregate should reflect reasonably conservative probabilities that contractholders will exercise options to take withdrawal or nonforfeiture benefits but may be less than the sum of the withdrawal and nonforfeiture benefits available under all contracts.

V. In determining the appropriate valuation interest rate, there are the following considerations.

A. The interest rate assumption used in reserve valuation should be based on a current industry "reference" rate which would apply to short term liabilities but should contain more margin for conservatism for those interest rates which are assumed to apply to the more distant future years in order to recognize the greater uncertainty associated with yields on investments at that time. The current industry "reference" rate could be defined as a current earnings rate derived from reported insurance industry experience. This rate could be updated by using its historical relationship to a published investment market index (e.g. BAA bond yields) and subsequently be verified by relating it to the reported industry experience. As a general rule, the valuation interest rates should decrease with duration to recognize that a life insurance company's business characteristically generates a net cash inflow.

B. The ultimate "natural" interest rate applicable to long term liabilities in the distance future should take no account of inflation and should be assumed to be about 3½% to 4%. This produces more conservative reserves than do other interest patterns for most products and in aggregate for likely mixes of business.

C. Reserve valuation interest assumptions should be chosen so that reserves will be adequate to meet, at a high confidence level, adverse long term experience fluctuations.

VI. Approaches to Establishing Minimum Statutory Reserve Requirements.

In considering ways to establish the above requirements, there are a number of alternatives. The principal of these are the following:

Alternative 1: In the past, the solvency test for life insurers has been based upon separate but consistent valuations of assets and of liabilities with solvency being defined in terms of the excess of assets over liabilities.

Alternative 2: Since products sold by life insurers typically involve a series of cash inflows and cash outflows stretching many years into the future, the solvency test for life insurers could be based upon a matching of the future flows of funds with the only net differences discounted on the basis of a valuation interest rate defined in the statute. Such a valuation interest rate would be based on that interest rate which equates to zero the present value of all the net differences in the future cash flows. The remaining matched cash inflows and cash outflows could be valued using such a valuation interest rate or any other interest rate applied consistently to matched cash inflows and cash outflows.

Alternative 3: However, since the future flow of funds for some life insurance products is difficult to project, life insurers could be given the option of using Alternative 2 for a particular group of assets and liabilities selected by the insurer. The remaining assets and liabilities with relatively unpredictable cash flows would be valued under the traditional approach of Alternative 1. (Alternative 3 would include safeguards to ensure that there is no imbalance as to future flow of funds in the remainder of assets and liabilities valued under Alternative 1. In addition, a means would have to be found to recognize future premium inadequacies.)

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ATTACHMENT F2

To: John O. Montgomery

From: W. Keith Sloan, Life and Health Actuary
Arkansas Insurance Department
Little Rock, Arkansas

Date: November 8, 1977

Re: Charles Howell Presentation

I have read Charles Howell's presentation to Concurrent Session N regarding interest assumptions with a great deal of interest (pun unavoidable) especially since his remarks are so very similar to those I have been making in our task force for the past several years. I have some fairly specific and probably rather niggling comments which I will mention, but I really think that this paper needs to be studied closely by all of our task force, not with an idea as to whether it should be implemented, but rather how and when.

In the items designated as I through III, I am in favor of deleting the word, "minimum." I agree with Charlie that the reserve structure should be a dynamic one, but a dynamic reserve structure does not imply a minimum or a maximum but a reserve.

Expanding a little on his section IVB, I would suggest that a dynamic reserve structure would make it possible to have for a mutual company a nonguaranteed (as to amount only) cash value structure as such instead of the present structure which is essentially the same with a guaranteed plus "dividends." It would be necessary to coordinate efforts with the Cost Comparison Task Force and possibly even the Unfair Trade Practices Subcommittee if such a structure were permitted because disclosure could be a problem. I would be thinking in terms of probable cash values being disclosed with an indication of a range. Along this line, his next Section IVC has some precedent in the 130% requirement which is fairly standard in credit insurance. This was brought up in our Boston meeting. This paper, however, suggests to me a way to handle the specific situation we were talking about in the credit area. There could fairly easily be a moderately conservative amount included in the policy reserve with a liability set up for surrender benefits during the coming year in excess of those contemplated in the policy reserve in a manner analogous to provision for current year's dividends, group experience refunds or similar items.

For solvency purposes, I think that the ideas in Charlie's Section V have merit, but I am far from sure that an industrywide reference rate could be determined rapidly enough to be usable. Such a rate, however, might be usable as a damping factor if it were perhaps a three-year average rate for the industry as a whole. Another possibility would be the use of the "natural" interest rate (VB) to value both assets and liabilities. This would work, of course, best for investments where there is a fixed dollar return, and even those should be valued as the present value of each income item weighted with some probability of getting it to take quality of investment into account. Equities almost have to be valued at either market or possibly a three-year moving average of market. A structure of this type, although it would not rule out some conservatism in the reserve structure as such, would actually imply that the provision for fluctuation in investment experience should be in the surplus or a separate reserve rather than in the policy reserve.

The above is really a vote for Alternative 2 in Section VI. I think that it is possible, and I think that it would add a great deal to regulation and to the business. It might even reduce the termination rate for life companies which in this country has run quite a consistent 4% per year.

There are, of course, some drawbacks. Such a system would totally baffle all examiners and probably a lot of people who are doing "actuarial" work for Departments. There would also have to be a heavy training program, and the concept needs to find its way into the textbooks as well as whatever the output of our task force turns out to be and the transactions of course. Very probably, the Blanks Committee would have to be fired and your task force would have to take over their function, at least termporarily.

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ATTACHMENT G1

To: Richard V. Minck
American Life Insurance Association

From: Robert A. Miller III
Vice President and Corporate Actuary
Aetna Life & Casualty
151 Farmington Avenue
Hartford, Connecticut 06156

Date: June 1, 1977

Re: Interest Assumptions for Single Premium Life Insurance Policies

The NAIC has proposed to change the valuation interest rate for annual premium individual life insurance to 4½% and the interest rate in calculating nonforfeiture values to 5½%. They have also proposed rates of 5½% and 6½% for valuation and nonforfeiture values respectively for single premium policies.

I have expressed considerable concern about the effect this latter proposal could have on insurance company solidity. The reason for my concern is that existing policyholders in good health will be able to use the cash value of policies under which they are now insured to buy substantial amounts of new single premium insurance and use the premiums they are now paying to buy new premium paying policies. Under these circumstances the combined amount of insurance under the new policies can be substantially larger than the amount under the replaced policy. Extensive "trading" of this kind could produce a heavy run on cash values. We have already seen in recent years what kinds of problems can be created by heavy outward flows of cash in the form of policy loans and that some very highly regarded companies have had real difficulty in coping with these problems.

You have asked me to give you an example of the kind of situation that can develop in an individual case using "real" gross premiums. I can't do exactly what you have asked because we can't be sure exactly what premium rates we would use if the 4½/5½% rates were to become available for annual premium policies and the 5½/6½% rates were to be available for single premium policies.

However, to give you an idea of what could happen, we have constructed an example using a hypothetical single premium rate and our current annual premium rates. These latter rates are based on an interest rate of 4% for valuation and nonforfeiture. The hypothetical single premium rate assumes the valuation/nonforfeiture rates of 4½/5½% (not 5½/6½%) and is based on the formula underlying our current single premium rates.

The example assumes that 20 years we sold an ordinary life policy with a face amount of $33,000 to a man then age 25. Today the cash value of that policy would be $8,415. If the man, who would now be age 45, were to take the cash value and apply it at our hypothetical rate, he could buy a single premium policy with a face amount of $37,438. He could then buy for the annual premium of $564.63 he had been paying for 20 years a new ordinary life policy with a face amount of $21,673. His insurance under the combined new policies would be $59,111 or 179% of the amount under his old policy.

This example does not assume the worst situation. The single premium rate might have been based on the 5½/6½% proposal, and our annual premium rate might have been based on the 4½/5½% proposal. We believe that the latter change would make only a small difference in the result. It's not possible for me to guess at what other companies might charge for the single premium insurance on the 5½/6½% basis.

We have already sent you other examples of the kind of increases in face amount that can be achieved by judicious trading of old policies for new. While those examples were not based on the same premium rate assumptions, they give an idea of how the results could be affected by changes in original insuring age and in the rate assumptions for single premium insurance. In evaluating the effect of changes in the single premium rate, I think it is better to think in terms of percentage change in face amount rather than in terms of percentage change in face amount rather than in terms of the amount itself and to think about how those differences could affect future costs.

In a separate letter, we outlined the results of an analysis we have made of the annual rates of yield developed by funds accumulated by annual premium and single premium policies at various durations. I believe that by themselves, those results indicate that a 5½% valuation rate is too high for any form of permanent life insurance at this time. I think the example in this letter provides another significant argument against moving to such a high rate.

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ATTACHMENT G2

To: Members of the Technical Advisory Committee With Respect to the Long Range Aspects of Valuation and Nonforfeiture Value Regulation

From: John C. Angle, F.S.A., Executive Vice President
The Guardian Life Insurance Company of America
201 Park Avenue South
New York, New York

Date: October 11, 1977

John Montgomery has notified you of a meeting of the NAIC technical task force on Saturday, October 22 and Sunday, October 23, in Boston. Some of you, I know, want to know if there is material affecting our committee that will be discussed and whether you should plan to attend the meeting.

The answer is that neither Mr. Montgomery nor I know of any items affecting the work of our technical advisory committee that will be discussed in Boston. Accordingly, there is no need for you to plan to attend the meeting. However, I should make it clear that you are welcome to attend any part of the meeting of Mr. Montgomery's committee.

Our committee continues to be on standby status. One possible future assignment will be to review the material still being assembled by the Central Office of the NAIC. That material consists of the convention annual statements of life companies that have become insolvent over the past years and which would be referred to us for analysis. A longer-range project will be the development of minimum capital requirements that should be met by any insurer wishing to continue to write new business. This will be particularly involved for those insurers with subsidiaries or in multiple lines of business.

I will write you again whenever your committee has substantive work to do.

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ATTACHMENT G3

To: (C) Committee Technical Task Force on Valuation and Nonforfeiture Value Regulation

From: A. J. Pasant, President and Chairman of the Board
Jackson National Life Insurance Company
5929 Executive Drive
Lansing, Michigan 48910

Date: September 27, 1977

Re: Life Insurance Agents Advisory Committee

I would like to thank you for the opportunity you provided David Pasant and myself to visit with you in regard to our position on the model bill and the legislation which is pending in the State of California. I was especially pleased to find that you are open-minded, and that you gave us an opportunity to present the agent's side of this legislation.

I certainly hope that you realize that we are very sincere in our objections to this particular portion of the model bill, and I deeply appreciate the offer you made which would enable a committee to be considered which would consist of life underwriters so that their position could also be considered in this legialation.

I am now in the process of attempting to secure the names of respected agents who would be willing to serve on such a committee, and, upon the completion of the list, I would like to have the opportunity to provide you the names so that you might make further consideration on the possibility of a committee being formed which would be representative of the life insurance agent's position on this bill.

I would again like to thank you for the gracious hospitality you extended Dave and I, and I certainly hope that we will meet again very soon so that we might discuss these and other matters.

VARIABLE LIFE INSURANCE AND VARIABLE ANNUITIES (C4) SUBCOMMITTEE

Reference:
1977 Proc. Vol. I p. 619
1977 Proc. Vol. II p. 580

Hon. Maximilian Wallach, Chairman – District of Columbia
Hon. Jerry B. Buxton, Vice-Chairman – Missouri

AGENDA

1. Report of the subcommittee meetings held since the June meeting in Minneapolis.

2. Comments on SEC regulation concerning "Guaranty Investment" annuities (No. 5838).

3. Discuss status of litigation regarding variable life insurance.

4. Any other matters brought before the subcommittee.

The meeting of the Variable Life Insurance and Variable Annuities (C4) Subcommittee was held in the Napoleon I Room of the Deauville Hotel on December 7, 1977, at 11:10 a.m. All members were present with the exception of Guam.

1. Report of Subcommittee Meetings Held Since the June Meeting in Minneapolis.

After breifly describing the meeting which was held in Washington on October 26, the Chairman invited comments. Paul Mason of the American Council of Life Insurance, urged adoption of the memorandum of November 21, 1977 as submitted. The memorandum (attached), including its proposed amendments to the VLI regulation, was adopted by voice vote.

2. Comments on SEC Regulation Concerning "Guaranty Investment" Annuities (No. 5838).

The Chairman explained the position contained in the NAIC statement regarding comments solicited by the SEC. He noted that the statement contains the philosophy and does not necessarily support the issuance of a given annuity by a specific insurance company. Annuities, however, must conform to state insurance laws rather than federal securities laws.

A motion was made to incorporate the NAIC statement of October 6, 1977 as a part of the proceedings of this committee. The motion carried (statement attached). New York abstained from voting.

3. Status of Litigation Regarding Variable Life Insurance.

The status of the litigation with the SEC regarding variable life insurance was updated and given by the Chairman as well as by the Deputy Commissioner of Connecticut, who stated that a suit will be actively pursued.

4. Other Matters.

The Chairman introduced for the record (attached) a state-by-state updated status report on variable life insurance and variable annuities laws and regulations.

John Montgomery, Chairman of the (C) Committee Technical Task Force to Review Valuation and Nonforfeiture Value Regulation, reported briefly on a proposed draft of a model regulation for variable annuities. The report was received by the subcommittee (attached).

There being no further business, the meeting was adjourned at 11:35 a.m.

Hon. Maximilian Wallach, Chairman, District of Columbia; Hon. Jerry B. Buxton, Vice-Chairman, Missouri; Hon. W.H.L. Woodyard III, Arkansas; Hon. Johnnie L. Caldwell, Groggia; Hon. Manuel A. Chaco, Guam; Hon. H. Pete Hudson, Indiana; Hon. Fletcher Bell, Kansas; Hon. Berton W. Heaton, Minnesota; Hon. John F. Lennon, Acting, New York; Hon. Peter F. Mullaney, Rhode Island; Hon. Lowell L. Knutson, South Dakota.

To: Variable Life Insurance and Variable Annuities (C4) Subcommittee

From: Maximilian Wallach, Chairman

Date: November 21, 1977

Re: Proposed Changes to the Variable Life Insurance Regulation

The (C4) Subcommittee met on October 26, 1977 in a working session to consider changes to the model variable life insurance regulation. In light of the fact that a quorum of the subcommittee was not present, a working session was declared in which the members present agreed to review the changes proposed by the industry, the responses of the NAIC staff (see attached memoranda), and to recommend certain changes to the subcommittee at its meeting in December 1977. These recommendations are detailed below. Brackets denote material that would be deleted from the current version of the regulation, and underlining represents added material.

A. Recommended Changes

1. Amend Article III Section 1b to provide an alternative method of compliance for changing investment policy and for meeting permissible investment standards as follows:

b. <u>either (1)</u> 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] <u>or (2) the insurer's investment policy, as described in the statement required to be filed under Subsection 2C of this Section, conforms to Section 3 of Article VI, and the Commissioner is satisfied that the procedures for changing the investment policy of a variable life insurance separate account, as described in the statement required to be filed under Subsection 2c of this Section, provide safeguards consistent with those provided under Section 6 of Article VI; and</u>

2. Amend Article III Section 2c to require a filing by the insurer of a statement of procedures for changing investment policy. This provision is a counterpart of the recommended revision of Article III Section 1b. The proposal follows:

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

3. Amend Article III Section 4a to allow the commissioner to waive the advertising filing requirement; and amend Article III Section 4b to recognize and incorporate the requirements of the NAIC Model Life Insurance Advertising Rules which were adopted by the NAIC in 1975 as follows:

a. <u>Until two years after delivery of its first variable life insurance policies in this state, and during any subsequent period upon the written request of the commissioner, an insurer shall file</u> all variable life insurance sales material, advertising material, and descriptive literature [shall be filed] (________ business days prior to use) (within ________ business days after use) with the commissioner [who] <u>The commissioner</u> 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,] <u>V</u>ariable life insurance sales material, advertising material, [or] and descriptive literature shall be subject to the additional requirements of (insert citation to the life insurance advertising rules as adopted by the NAIC). [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 letter; and

(3) prepared sales talks, presentations, and material for use in the sale of variable life insurance.]

4. Amend Article IV Section 3c to add a technical correction which requires payment of premiums plus interest for incidental benefits in the event of reinstatement under the 110% cash value alternative as follows:

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 <u>with interest at a rate not exceeding ______ percent per annum compounded annually</u> 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 per annum compounded annually; or

(2) 110% of the increase in cash surrender value resulting from reinstatement <u>plus all overdue premiums for incidental insurance benefits with interest at a rate not exceeding ______ percent per annum compounded annually.</u>

5. Delete Article IV of Section 3f and reletter remaining subparagraphs. The deletion of the 18-month exchange privilege is intended to make regulation of variable life insurance consistent with that of fixed benefit products. It was the consensus of those attending the working session that the "free look" provided in Article IV Section 3a is sufficient to allow purchasers to reevaluate their purchase decisions as necessary. There was a suggestion that the subcommittee consider lengthening the duration of the free look to 30 or 60 days (see Article IV Section 3a). The deleted material follows:

[a. 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) must apply as an advance premium 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) shall not require evidence of insurability for this exchange.]

6. Amend Article IV Section 3o to limit application of the six-month deferral provision to payments which do not depend on the investment performance of the separate account. This revision recognizes that such payments will be based upon market values of separate account assets. Therefore, there would be no detrimental run on insurer assets disposed of at inopportune times. The revised provision follows:

o. 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, <u>if such payments are based on policy values which do not depend on the investment performance of the separate account</u>, or

(2) <u>otherwise,</u> 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.

7. Amend Article IV Section 4b by adding language to mandate the availability of loans only after the payment of premiums for a specified number of years in the same manner as applicable to fixed benefit life insurance. The revised provision follows:

b. A provision for policy loans <u>after (insert number of years specified by state law provision on availability of policy loans for fixed benefit life insurance) full years' premiums have been paid</u> (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. . . .

8. Amend Article VI Section 10 to authorize investment advisory contracts to be placed with an investment manager who is subject to the Employee Retirement Income Security Act (1974) with respect to an employee plan. The revised language follows:

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 any of 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 person providing such advise is an investment manager under the Employee Retirement Income Security Act of 1974 with respect to the assets of each employee benefit plan allocated to the separate account; or

(3)[(2)] the insurer has filed with the commissioner and continues to file annually the following information and statements concerning the proposed adviser. . . .

9. Amend Article VII to add language providing for the alternative delivery of disclosure information pursuant to the 1974 Federal Pension Law (ERISA) if policies are exempt from the federal securities laws but subject to ERISA. The revised introductory text of Article VII follows:

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 to the extent that a disclosure containing information required by this Article is delivered, either in the form of: (1) a prospectus included in a registration statement relating to the policies which satisfies the requirements of the Securities Act of 1933 and which was declared effective by the Securities and Exchange Commission; or (2) all information and reports required by the Employee Retirement Income Security Act of 1974 if the policies are exempted from the registration requirements of the Securities Act of 1933 pursuant to Section 3(a)(2) thereof, [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.]

10. Delete Subsections 2e and 2g of Article IX and reletter remaining subparagraphs. These provisions were drawn from the federal securities laws and are not considered relevant or desirable for variable life insurance. The text of the deleted provisions follows:

[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 11 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 purpose 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.]

[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;]

11. Amend the regulation by adding a new Article X which allows commissioner discretion in determining compliance of a foreign company with the model regulation state. Remaining articles would be renumbered. The new provision follows:

Article X. Foreign Companies.

If the law or regulation in the place of domicile of a foreign company provides a degree of protection to the policyholders and the public which is substantially similar 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.

B. Further Comments

In addition to the above-mentioned changes now being recommended by the subcommittee members in attendance at the working session, there were also views expressed on certain other proposed changes. A summary of these points is included for your information.

1. Article VI Section 6. In connection with the amendments proposed on investment policy and insurer changes thereof, it was concluded that the commissioner's hearing procedures for changing investment policy should be retained.

2. Article VI Section 2. The issue of revising the mandatory policy benefit and design requirements to allow sales of other than whole life contracts and to eliminate the minimum multiple requirements was deemed better left to the full subcommittee without an opinion from the working session. It was recognized that acceptance of the industry proposed changes could result in the marketing of variable life insurance products with more significant investment aspects than those presently permitted. It was also noted that the SEC is arguing in pending litigation (relating to specialty participating life insurance contracts (not variable life insurance), Grainger v. State Security Life Insurance Co., 5th Cir.) that the minimum multiples used for variable life insurance represent "an implicit recognition that, at some point, the investment aspect of an insurance policy assumes sufficient importance so that it is a security for purposes of the federal securities laws."

3. Article VI Section 1c and Section 7. The industry proposal suggests deletion of the separate account asset charge limitations. The subcommittee members present at the working session agreed that these limitations could be replaced by disclosure requirements that would allow applicants to understand the effects of variation among insurers of such charges. One acknowledged possibility was the displaying of hypothetical policy values assuming several standard and prescribed assumptions.

4. Article IV Section 9. The industry proposal is to delete much of the conflicts of interest provisions. While no recommendation is now made for the deletions included in the industry proposal by the members present at the working session, it is clear that the final sentence of Section 9a should be given separate consideration from the remainder of Section 9. The subject matter of the final sentence of 9a relates to the responsibility of the insurer's board of directors for separate account actions. This is a distinct issue that should not be comingled with the remainder of Section 9 issues. It was the consensus of the members present at the October 26 meeting that the Section 9a provision be retained.

To: Variable Life Insurance and Variable Annuities (C4) Subcommittee

From: Larry D. Gilbertson, Special Counsel
Aetna Life & Casualty
777 Leesburg Pike
Falls Church, Virginia 22043

I have attached a map which indicates which states have adopted laws or regulations authorizing or relating to variable life insurance.

I have also included a summary of the states which have authorized either the SEC registered variable contracts or the nonregistered contracts used only in qualified plans, for two companies – Aetna and Equitable.

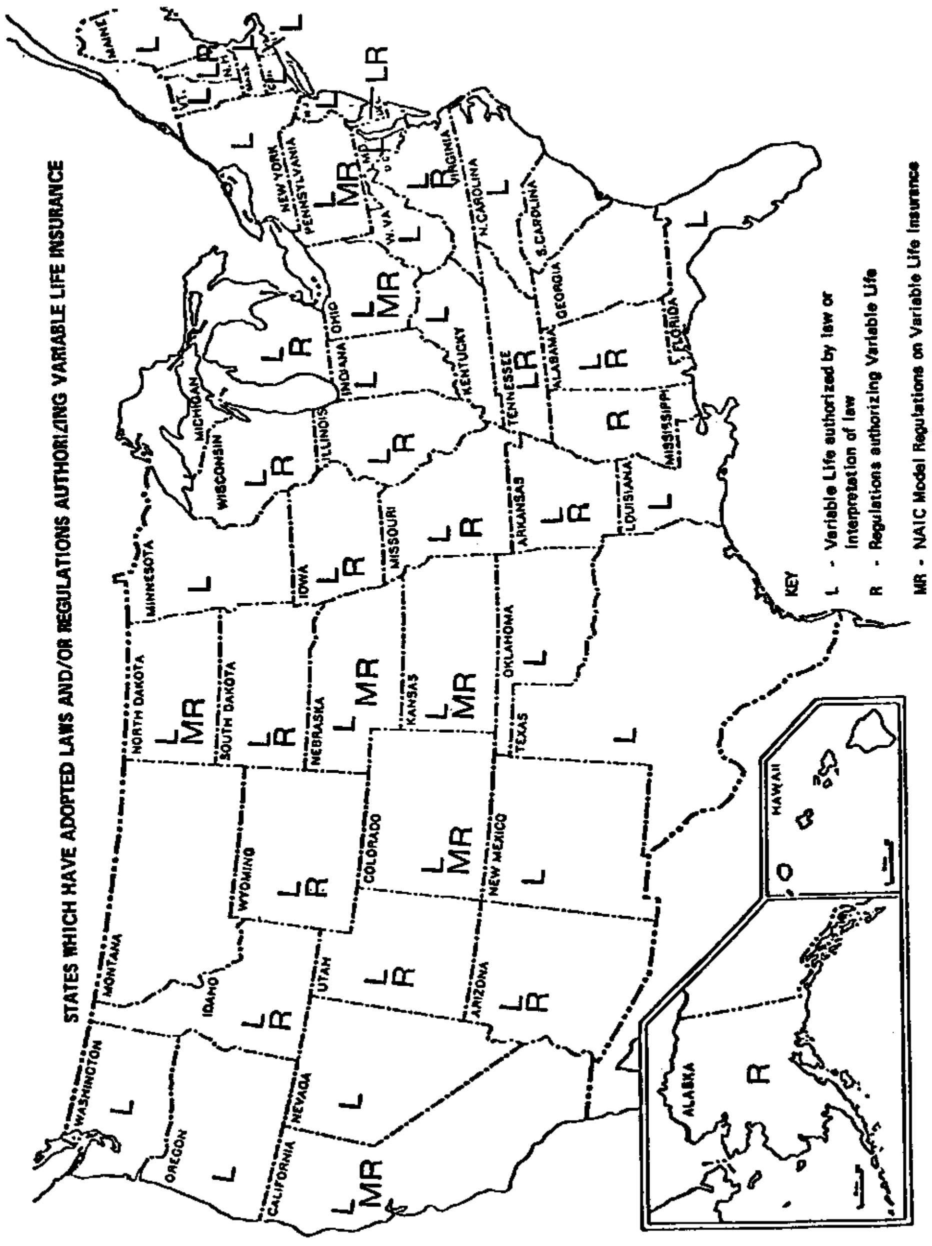
On the map, the category "R" shows the states where regulations follow the format of the 1969 Model Regulations adopted in New Orleans. Although these vary in some states, they all authorize the issuance of variable life insurance contracts.

The category "MR" (Model Regulations) relates to the regulations approved in 1974. These have been basically unchanged since that time. There are several proposed amendments pending to the Model Regulations.

Variable Life Policy Approvals by States for Aetna Variable Life & Equitable

Key: A = Aetna Variable – nonregistered contracts in qualified plans only. E = Equitable – SEC-qualified contracts written in all markets.

1. Alabama . . . A . . . E
2. Alaska . . . A
3. Arizona . . . A . . . E
4. Arkansas . . . A . . . E
5. California . . . A . . . E
6. Colorado . . . A
7. Connecticut . . . A
8. Delaware . . . A . . . E
9. Florida . . . E
10. Georgia
11. Hawaii
12. Idaho . . . A . . . E
13. Illinois . . . E
14. Indiana
15. Iowa . . . E
16. Kansas . . . E
17. Kentucky . . . A
18. Louisiana . . . A . . . E
19. Maine
20. Maryland . . . A
21. Massachusetts . . . E
22. Michigan
23. Minnesota . . . A
24. Mississippi
25. Missouri . . . A . . . E
26. Montana
27. Nebraska . . . A . . . E
28. Nevada
29. New Hampshire . . . A . . . E
30. New Jersey . . . E
31. New Mexico . . . A . . . E
32. New York . . . E
33. North Carolina
34. North Dakota . . . A . . . E
35. Ohio . . . A . . . E
36. Oklahoma . . . E
37. Oregon . . . E
38. Pennsylvania
39. Rhode Island . . . E
40. South Carolina
41. South Dakota . . . E
42. Tennessee . . . A . . . E
43. Texas
44. Utah . . . A . . . E
45. Vermont . . . E
46. Virginia
47. Washington . . . E
48. West Virginia . . . A
49. Wisconsin . . . E
50. Wyoming . . . E
51. District of Columbia
52. Guam
53. Puerto Rico


STATES WHICH HAVE ADOPTED LAWS AND/OR REGULATIONS AUTHORIZING VARIABLE LIFE INSURANCE
KEY
L - Variable Life authorized by law or interpretation of law
R - Regulations authorizing Variable Life
MR - NAIC Model Regulations on Variable Life Insurance

To: Hon. Maximilian Wallach, Chairman
Variable Life Insurance and Variable Annuities (C4) Subcommittee

From: Richard A. Hemmings
NAIC Counsel

Date: October 28, 1977

Re: Current Review of VLI Regulation

For your current review of the NAIC Model Variable Life Regulation, I have enclosed for your review, a memorandum prepared by the NAIC Central Office in response to the ACLI proposed changes. The memorandum dated October 18, 1977 is a summary of more detailed comments appearing in the memorandum dated September 9, 1976 (1977 Proc. I 623). The extensive commentary adopted by the subcommittee, of course, provides the most detailed account available of the subcommittee's drafting rationale.

As you will recall, I was also asked at the June 8, 1977 meeting of the (C4) Subcommittee to provide a written summary of matters pertaining to SEC regulation of variable life insurance and development of the NAIC regulation. I have enclosed materials previously prepared for the subcommittee which I believe are responsive to the subcommittee's request. An enclosed memorandum dated December 6, 1976 recapitulates the SEC's involvement with variable life insurance.

I hope this material will be of some assistance to the subcommittee in your ongoing review of the NAIC Variable Life Insurance Regulation. Copies of this letter and the enclosures have been provided to the subcommittee members.

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To: Variable Life Insurance and Variable Annuities (C4) Subcommittee

From: Richard A. Hemmings
NAIC Counsel

Date: October 18, 1977

Re: Proposed Changes -- VLI Regulation

In May 1976 the American Council of Life Insurance (ACLI) furnished the (C4) Subcommittee with "Recommended Changes to the NAIC Model Variable Life Insurance Regulation." At the June 1976 meeting of the subcommittee, I was asked to review the industry proposed changes. Thereafter, on September 9, 1976, the (C4) Subcommittee was furnished with an NAIC Central Office memorandum on the proposed changes which, where appropriate, included disposition recommendations (see 1977 Proc. I 623.)

In November 1976, the (C4) Subcommittee Chairman asked the ACLI for further comments on the proposed changes and its reaction to the September 9, 1976 NAIC staff memorandum. The ACLI responded with written comments on November 19, 1976 (Ibid)., 620). The issues raised in connection with the proposed changes to the model VLI regulation have since remained dormant.

The purpose of this memorandum is to provide a current and brief review of the proposed changes and the NAIC staff recommendations. The staff recommendations remain an attempt to predict the type of response to the industry proposals that might have been forthcoming from the original drafting task force of the (C4) Subcommittee. Staff comments have been based, to the extent possible, upon earlier (C4) background comments and drafting materials, given the different, current circumstances.

1. Permissible Investments (Art. III Sec. 1b)

The staff recommends that the industry proposed revision be accepted. The proposed change would, in effect, eliminate the state-to-state "substantial similarity" requirement for permissible investment by adding an alternative substitute allowing the actual investment policy of the insurer to follow the permissible investments of the promulgating (model regulation) state.

2. Changes in Investment Policy (Art. III Sec. 1b and Art. VI Sec. 6)

The NAIC staff recommends rejection of the ACLI's proposal to add an alternative "consistent safeguards" method for changing investment policy. The industry suggested alternative is premised on the applicability of SEC required voting rights in lieu of the state public hearing requirement, used whenever the Commissioner finds a "material change" in investment policy. Addition of the "consistent safeguards" alternative would, as a practical matter, effectively void the substantial similarity requirement. Unless the NAIC is prepared to acquiesce to SEC regulation and the federal application of voting rights, the industry proposal should be rejected.

As the ACLI points out in their comments of November 29, 1977, there is some question whether VLI companies domiciled in New York, Michigan, Colorado or other states not meeting the substantial similarity test should now be permitted to write business in model regulation states. The (C4) Subcommittee intended to promote both uniformity in at least the important aspects of VLI regulation among the states and uniform treatment of policyholders in the event they objected to a change in investment policy. Neither purpose would be strengthened by adopting the industry recommendation.

3. Filings (Art. III Sec. 2c)

The proposed change adding a filing requirement of procedures for changing investment policies should be accepted or rejected consistent with the decision on item 2 above (Changes in Investment Policy).

4. Use of Sales Materials (Art. III Sec. 4)

The Council recommends a change that would delete the definition of sales and advertising, and delete the advertising material filing requirement. The basis for the change is the subsequent adoption of NAIC life advertising rules which are applicable to VLI. Notwithstanding the NAIC life advertising rules, it is recommended that the VLI regulation's advertising provisions be retained on at least an interim basis. The VLI regulation now provides for filing, and unlike the generally applicable NAIC life advertising rules, this filing requirement was intended to provide initial comprehensive oversight to assure that the new VLI product meets life insurance advertising standards.

5. Mandatory Policy Benefit and Design Requirements (Art. IV Sec. 2)

The Council proposes to delete some of the limiting characteristics accepted by the (C4) Subcommittee in drafting the VLI regulation. The changes are based by and large upon the applicability of SEC controls. Elimination of the following requirements is proposed:

(1) Lifetime coverage;
(2) Minimum multiples;
(3) Limitations on policy design to the so-called New York Life design or the Equitable design; and
(4) Nonforfeiture benefit increase in the event premiums exceed formula level.

Elimination of lifetime coverage and minimum multiple provisions would expand insurers' ability to develop new VLI products, such as endowment contracts. It is fairly clear that revision of the regulation as proposed could lead to introduction of policies with investment characteristics that are even more significant than current, permitted designs. This obviously is a sensitive subject so long as SEC regulation is opposed by the NAIC. For this reason, the staff presently recommends rejection of these proposals.

With respect to the New York Life and Equitable design limitations, the staff recommends rejection of the industry proposal on the basis that the (C4) Subcommittee sought to limit the variety of product designs in the early stages of VLI marketing in order to develop experience. Little or nothing has happened in intervening years that would warrant a revision in regulatory posture.

The deletion of the nonforfeiture benefit increase when premiums exceed a certain level (Art. IV Sec. 2j) may again have some relevance to the NAIC's ability to successfully argue against SEC jurisdiction. The provision was, at least in part, an NAIC response to the SEC's concern with excessive sales, administrative and management changes. It is questionable whether the states currently have statutory authority to regulate rates as envisioned by Art. IV Sec. 2j, and the provision is certainly difficult to understand. However, it may be desirable to defer consideration of this item pending resolution of the state-SEC jurisdictional dispute. Since the recently developed NAIC life insurance cost disclosure regulation is not applicable to VLI, the NAIC may wish to consider development of price disclosure rules or, perhaps, some other form of rate regulation in lieu of section 2j.

6. Policy Reinstatement (Art. IV Sec. 3c)

The proposed changes (a) add clarifying language to assure the application of interest to back premiums paid on reinstatement and (b) specify payment of premiums for incidental benefits plus interest on the 110% cash value alternative. The Council furnished additional explanatory comments on November 29, 1976 which appear to be consistent with the intent of the subcommittee in drafting section 3c. When the 110% cash value payment alternative is in effect for reinstatement (i.e. when premiums plus interest are less than the reinstatement increase in cash value), then payment of the cash value increase plus past due premiums plus interest for incidental benefits seems necessary to avoid inequitable, unintended results. The NAIC staff recommends acceptance of the proposed changes in section 3c.

7. 18 Month Exchange Privilege (Art. IV Sec. 3f)

The Council has proposed revision of the 18 month exchange provision to make it work equitably. The proceedings of the (C4) Subcommittee leave no doubt that further revision of the exchange privilege was anticipated. It was also anticipated that an NAIC actuarial task force would review proposed changes to this provision. It is, therefore, recommended that this subject be referred to an appropriate actuarial task force.

8. Deferred Payment of Death Benefits (Art. IV Sec. 3o)

According to the deferral provision, policies must include a provision permitting a six month delay in payment of benefits in the event of economic emergency. The ACLI argues that the deferment right is "inappropriate for variable benefits since, at the time of any surrender or loan request, the levels of variable cash values . . . simply reflect the market value of the separate account assets at that time." The Council would add language making the deferral applicable only to policy values which do not depend on the investment performance of the separate account (e.g. minimum death benefit). In light of the additional comments provided by the Council on November 29, 1976, the proposed change is not objectionable in the opinion of the NAIC staff. The staff recommends acceptance of this proposed change.

9. Settlement Options – Fixed Basis Only (Art. IV Sec. 3p)

The regulation currently prohibits settlement options not provided on a fixed basis. The subcommittee's rationale was simply to preclude any question of SEC jurisdiction. Disposition of this recommendation should, perhaps, await further clarification of the jurisdictional dispute.

10. Policy Loans (Art. IV Sec. 4b)

The Council proposes to amend the policy loan provision by inserting language which would mandate the availability of loans only after the payment of premiums for a specified number of years. It is recommended by the NAIC staff that the Council's proposed change be accepted with one caveat. The apparent purpose served by inclusion of the additional language is apparently similar to that for other life insurance forms – namely the failure for a period of time to build significant cash values upon which policy loans may be based. The caveat to acceptance of the Council's amendment is that if the SEC scheme of regulation requires an early buildup of cash values, which it apparently does, then policy loans should be made available at the time a significant cash value exists.

11. Charges Against the Separate Account (Art. VI Sec. 7a(4) and Art. VI (Sec. 1d)

The regulation now specifies permissible charges that may be deducted from the separate account for investment management expenses and other items. The Council proposes to delete the specified maximum investment management charges which range from .3% to .75% of separate account assets depending on the value of the assets and to delete the .5% maximum charge for mortality and expense guarantees. It is strongly recommended that the asset charge limitations for investment management and mortality and expense guarantees be retained. The specified limitations tend to avoid subtle distinctions in policy benefits and costs that may not be readily apparent to VLI purchasers. In drafting the regulation, the subcommittee noted an apparent relationship between premiums and asset charges which led to the asset charge limitations. It was the subcommittee's intention to shift price competition to the premium on the basis that policy cost to the policyholder is more visible in the premium than in an asset charge or hypothetical illustrations of future benefits.

12. Standards of Conduct (Art. VI Sec. 8) and Conflicts of Interest (Art. VI Sec. 9)

Various deletions are proposed that the Council argues would return VLI regulation to the type of traditional controls exercised over other life insurance products. The VLI regulation now includes detailed provisions on Conflicts of Interest that, by and large, would be deleted by the Council's proposed change. Much of the present conflict of interest provisions were recommended by the Council at the time when it was anticipated that the SEC would defer to state insurance regulation under Rule 3c-4. The conflicts of interest provisions also reflected the subcommittee's concern with the equitable participation by the separate account in transactions that also involve the general account. These concerns have not been diminished by events occurring since adoption of the VLI regulation. It is, therefore, recommended that the conflict of interest provision be retained.

In particular, the last sentence of Art. VI Sec. 9a was included to prevent SEC-Investment Company Act policyholder voting rights because the subcommittee determined such rights to be inappropriate to VLI. This sentence provides that the "Board of Directors of the insurer shall be responsible for all acts concerning the separate account." In other words, only the board, not the policyholders, could change the separate account investment policy for example. The subcommitee sought to avoid putting control of the separate account directly in the hands of VLI policyholders because of the intimate relationship of the general and separate accounts. This provision in Sec. 9a should be retained or replaced with other language elsewhere in the regulation specifically prohibiting application of Investment Company Act voting rights.

13. Investment Advisory Services (Art. VI Sec. 10)

It is recommended that the specific changes proposed by the Council in the text of the regulation furnished by them on December 8, 1975 be accepted. These changes relate to the 1974 pension law and deletion of a provision concerning a written investment advisory agreement and its termination. These items appear to be housekeeping changes that are not objectionable.

However, the Council's explanatory comments provided on April 30, 1976 seem to infer that other revisions are being recommended. Review of the current industry proposals appears to be necessary.

14. Information Furnished to Applicants (Art. VII)

Deletion of the detailed disclosure requirements contained in Article VII is proposed by the Council. Replacing the NAIC disclosure would be SEC and ERISA disclosure requirements. It is recommended by the NAIC staff that the additional proposed language pertaining to ERISA be accepted, but the deletion of other disclosure requirements be rejected. Despite the involvement of the SEC, the commentary to the model regulation makes clear the subcommittee's intent to retain control over disclosure rules.

15. Reports to Policyholders (Art. XI Sec. 2)

There is no reason for eliminating the reporting requirements of Sec. 2 that can be supported by events transpiring since adoption of the regulation. The Council proposes to delete all of the annual reporting requirements (Sec. 2) because they are "burdensome and unnecessary." The Council had ample opportunity for input on the content of this provision when drafted.

16. Foreign Companies (Art. X)

The NAIC staff recommends that the proposed addition of Art. X be rejected. The provision gives formal recognition to a procedure to waive requirements of the model regulation when the commissioner finds "substantially equal" regulation in the state of domicile. The need for such a provision has not been fully explained.

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To: Hon. T. F. Gilroy Daly, Chairman, Variable Life and Variable Annuities (C4) Subcommittee

From: Richard A. Hemmings

Date: December 6, 1976

Re: Variable Life Insurance -- Recapitulation of the SEC's Involvement Culminating With Adoption of Rule 6e-2

A. Industry Proposal

The NAIC's participation in SEC proceedings on variable life insurance was preceded by an ACLI position memorandum filed with the Commission in 1970. The life insurance industry had for some years been looking at the possibility of developing new products to stimulate further life insurance purchases. What was needed was a product offering better methods of dealing with the effects of an inflationary economy on cash value life insurance. In 1969, three actuaries of the New York Life Insurance Company prepared a paper for the Society of Actuaries that detailed a variable life insurance proposal that was actuarially feasible. The industry soon began in earnest to develop such a product and review anticipated regulatory requirements.

In light of the variable annuities litigation in the 1960's, the industry sought to resolve the question of SEC jurisdiction over the new variable life product prior to marketing. The first industry efforts were directed merely at obtaining an informal decision by the SEC not to attempt any exercise of jurisdiction over variable life insurance. These discussions took place in the fall of 1970.

However, by 1971, the SEC staff had decided against the industry proposal and notified the industry that it should file a formal application for a declaratory order by the Commission concerning the status of variable life insurance and its issuers under the federal securities laws. In the fall of 1971 the industry accepted the fact that a proceeding involving a public hearing was inevitable, but expressed its opinion to the SEC that such a proceeding should be a rulemaking one rather than a declaratory order.

The industry and the SEC agreed to a rulemaking proceeding that was commenced with an ALC-LIAA (ACLI) "Petition for Issuance and Amendment of Rules." Industry proposed exemptive rules under the 1933 Securities Act, the 1934 Securities and Exchange Act, the 1940 Investment Company Act and the 1940 Investment Advisors Act.

According to the industry the purpose of the proposed exemptive rules was to avoid the difficulties that would emerge in regulation of variable life insurance under the Securities laws.

In the words of industry:

> The purpose . . . is . . . to have the Commission exercise its statutory authority to issue and amend rules which would eliminate any question as to the compliance with the federal securities laws of variable life insurance policies which, as hereinafter described, are so designed that their basic and predominant purpose and function is to provide protection against death. Petitioners submit that such a decision would be in accordance with sound regulatory policy. The administrative burdens of federal regulation of variable life insurance would substantially exceed the administrative burdens of regulating variable annuity products. In the variable annuity area, it has been found highly difficult to separate the investment element from the insurance element for purposes of regulation. In the case of variable life insurance, where the insurance element is by far the most important and where the investment element is merely incidental to the level premium payment method, the difficulties would be compounded many times. Federal regulation of variable life insurance and of the insurance companies writing such policies under statutes designed for a different kind of product would almost certainly involve serious conflicts with the life insurance laws administered by the states. Accordingly, there are sound regulatory and practical reasons for the Commission's making this decision at the outset and avoiding even more expensive and time-consuming case-by-case handling than occurred with the variable annuity. (Petition at 8-9).

Contrary to the opinions and assertions of industry, the SEC concluded that the rulemaking proceeding would go beyond the issuance of the proposed rules and also consider the issue of whether variable life insurance is subject to the federal securities laws.

B. SEC Proceeding

The SEC instituted an informal, public rulemaking proceeding in 1972. The initial public hearing phase began on April 10, 1972 and ended in June. There were 23 days of hearings which resulted in over 2,300 pages of testimony accompanied by 85 exhibits, including sales materials and other supplemental data.

There were five primary participants in the proceedings on the proposed exemptive rules:

(1) SEC Division of Investment Management Regulation;
(2) Petitioners (life insurance industry);
(3) NAIC;
(4) Investment Company Institute (ICI); and
(5) Mutual Fund Group (MFG).

The SEC involvement as a participant was that of an interrogator. The petitioners, of course, favored the exemptive rules proposal, and the ICI and MFG opposed the proposal.

The NAIC participation in the hearings was aimed at developing the argument that the SEC has no jurisdiction over variable life insurance – either to exempt it or actively regulate it. The NAIC testimony focused on the fact that under the McCarran Act, the securities laws and state insurance law, variable life insurance must be considered to be within the exclusive jurisdiction of the states.

In addition to oral testimony, the participants also submitted written memoranda of views. On August 21, 1972, the NAIC submitted its memorandum of views which detailed the inapplicability of the securities laws and the prohibition of SEC involvement based on the McCarran Act. In response to the memoranda submitted by other participants, the NAIC filed a reply memorandum on September 22, 1972. The reply memorandum briefly restated the original NAIC views and rebutted the applicability of the variable annuity cases in establishing SEC jurisdiction and corrected several misconceptions asserted in other participants' memoranda about the general nature of insurance and variable life insurance.

The starting point for the public hearings was, of course, the industry petition containing the proposed rules and some limiting characteristics for variable life insurance. The proposed exemptive rules would have applied only to variable life insurance policies that (1) provided insurance protection for the whole of life; (2) stated an initial death benefit and guaranteed payment of at least this amount; (3) provided that the amount payable on death would at least equal a minimum multiple of the gross premium for that year; and (4) were entirely life insurance contracts subject to regulation under state insurance laws. These four limiting characteristics of variable life insurance were agreed upon by the task force of the ALC-LIAA Joint Subcommittee on Variable Contracts and Separate Accounts in 1970. The purpose of these requirements was to narrow the concept of variable life insurance for the discussions with the SEC.

The essense of the proposed exemptive rules was to relieve insurers of the regulatory requirements of the securities laws for variable life insurance policies which qualified within the criteria expressed above. Together, the testimony and exhibits formed a comprehensive record of the existing state of variable life insurance development and the anticipated regulatory issues to be resolved.

These documents with the written memoranda served as the basis for a 180 page SEC staff study on variable life insurance. The broad recommendation in the staff study was that the commission not adopt any of the blanket exemptions proposed in the petition. On the very important Rule 3c-4 (1940 Investment Company Act) the staff said

> On balance . . . based on the record, the staff recommends an approach which would develop specific exemptions from the Investment Company Act rather than provide the total exemption of proposed Rule 3c-4.

The first stage of SEC staff activity on variable life insurance was culminated by these recommendations.

The Commission, however, did not follow the recommendations of the staff with respect to the important Rules 3c-4 (Investment Company Act) and 202-1 (Investment Advisers Act). On January 30, 1973, the SEC announced that it had determined that the investment character of variable life insurance would make such contracts securities so that any public offering would have to be registered under the 1933 Securities Act. Likewise, people selling variable life insurance would have to register as broker-dealers under the 1934 Securities Exchange Act. However, although the separate account established for variable life insurance would otherwise be an investment company subject to the 1940 Investment Company Act, the Commission exempted qualifying variable life insurance from the Act in deference to state regulation of insurance. The Commission noted the "complex administrative problems that would arise in providing substantial exemptions . . . necessary to make feasible operations of these [separate] accounts." Furthermore, an insurance company providing the investment advice incidental to the issuance of variable life insurance contracts was exempted from the otherwise applicable 1940 Investment Advisers Act.

The Commission explained its determination to exempt variable life insurance from the two acts that have principal application to mutual funds:

> The principal reason is that to reconcile the regulatory scheme of the Act with state regulation of insurance – which unquestionably is applicable to variable life insurance – would at the very least be difficult. It probably could not be done without interfering to some degree with the orderly development of state regulation. (Emphasis supplied.)

This Commission determination was the last step in the rulemaking proceeding initiated by the life insurance industry. Life insurers had gained a major part of their objective in the exemptions afforded by the Commission. The mutual funds had lost this battle, but as we now know, not the war.

C. The Exemptive Rules

1. The Proposed and Adopted Rules. The question of jurisdiction by the SEC over variable life insurance had been settled by the Commission's determination in January 1973 that variable life insurance was a security. The full force of the Securities Act and the Securities Exchange Act would apply to variable life insurance sales. The exemptive rules acknowledged the apparent differences of variable life insurance from other investment products subject to the securities laws.

Slightly over one year had elapsed from the filing of the industry proposed Rules 3c-4 and 202-1 to their adoption by the SEC. The rules adopted by the SEC were identical to the proposed industry rules.

The exemptive rules were relatively short and simply exempted separate accounts and their insurance companies if the accounts are derived solely from variable life insurance and are not used for variable annuity contracts. The term "variable life insurance" was restrictively defined as contracts:

(1) With whole life protection;
(2) Whic provided an initial stated amount of death benefit and guaranteed payment of at least that amount;
(3) Which provide an amount payable on death at least equal to specified minimum multiples of the gross premium payable in any year; and
(4) Which are entirely life insurance contracts subject to state insurance regulation.

Advisory services provided incidental to the conduct of the business of issuing such variable life insurance policies were not within the definition of "investment adviser" in the 1940 Investment Advisers Act.

2. Judicial Challenge to the Exemptive Rules. Within a month of the adoption of Rules 3c-4 and 202-1, the mutual funds petitioned the Circuit Court of Appeals for the District of Columbia for review of the SEC action.

According to the petition:

> variable life insurance contracts offer investors the essential ingredient of a mutual fund. . . . professional management of a diversified portfolio of securities. . . . The Commission erred and exceeded its statutory authority in adopting Rules 3c-4 and 202-1.

The requested relief was that the court set aside the exemptive rules and thereby subjected variable life insurance to the Investment Company Act and the Investment Advisers Act.

Shortly thereafter, the NAIC requested leave to intervene in the proceedings to raise the issue of jurisdiction. The issues raised by the mutual funds were (1) whether the SEC abused its discretion in adopting the exemptive rules; (2) whether it wrongfully delegated its authority; (3) whether it acted in excess of statutory authority; and/or (4) whether it was arbitrary and capricious.

In September 1973 the NAIC filed its brief raising additional issues for review, inter alia: (1) whether variable life insurance contracts, as defined in Rules 3c-4 are "contracts of insurance" entitled to exemption from federal regulation under the federal securities laws and by virtue of the McCarran Act; and (2) whether the separate account funding variable life insurance is an "investment company" under the Investment Company Act of 1940. The NAIC position in the litigation was the same as in the earlier SEC proceeding, i.e. that the Commission lacked jurisdiction, power and authority ab initio to promulgate any rules concerning variable life insurance -- exemptive or otherwise.

Briefs were prepared and submitted in this litigation by the mutual funds, the life insurance industry and the NAIC. The NAIC brief comprehensively developed the arguments against SEC jurisdiction.

The NAIC argued that the Commission lacked authority to promulgate the exemptive rules because variable life insurance contracts are contracts of insurance and, thus, qualify under the exemptive provisions of the federal securities acts. Furthermore, it was argued that variable life insurance is not a security. Alternatively, the NAIC argued that even if variable life insurance were found to be a security, the separate account funding variable life insurance is not an investment company under the 1940 Act. An additional alternative argument was that if variable life insurance separate accounts were held to be subject to regulation under the 1940 Act. Then the SEC acted within its authority in promulgating Rules 3c-4 and 202-1.

A cloud came over the course of events leading to a judicial resolution of these issues when the SEC issued a "Notice of Proposal to Amend Rule 3c-4 . . . and [Rule] 202-1 . . . To Condition The Exemptions . . . On a Determination by the Commission that Applicable State Laws or Regulations Provide Protections Substantially Equivalent to the Relevant Protections Afforded by the Investment Company Act and the Investment Advisers Act."

This prior approval concept represented a retreat by the SEC that could directly affect the original issues raised by mutual funds. Consequently, prior to filing any brief, the Commission moved the court to postpone further proceedings pending SEC determination of the final form of the exemptive rules.

Over the lone objection of the NAIC, the court granted the motion for postponement on December 26, 1973. For reasons described below, this, for all practical purposes, ended the litigation.

3. The Proposed Amendments. In late 1973 the Commission became concerned that variable life insurance contracts "might be sold to the public prior to the development of appropriate state regulation." The Commission noted that the NAIC would not approve the model regulation for variable life insurance until December of 1973 "at the earliest." In the SEC's view, various states might allow sales of variable life insurance without the development and implementation of the regulatory controls contemplated in the NAIC model regulation. For this reason, the SEC proposed in September 1973 to condition the exemptions contained in Rules 3c-4 and 202-1 upon a determination by the SEC that the state laws or regulations affecting the separate accounts be "substantially equivalent" to the relevant protections of the Investment Company Act and the Investment Advisers Act.

The proposed amendments specified five areas within which the Commission would determine the substantial equivalence of state laws to the federal securities laws. These were:

(1) Valuation of portfolio securities in a uniform manner;
(2) Annual reporting to contractholders;
(3) Prohibitions against unauthorized changes in investment policy;
(4) Protection against excessive management fees; and
(5) Protections similar to the federal law restrictions on transactions with affiliates.

In addition, the SEC requested comments on whether 11 additional areas of concern should be added to conditions to the exemptive rules requiring substantially equivalent state law.

In November 1973, the NAIC submitted comments on the SEC's proposed amendments.

The NAIC had rejected the authority of the SEC to regulate VLI from the outset of the SEC proceedings. However, the exemptive rules approach had been seen as a workable accommodation with the SEC concerns because there was to be no direct intervention by the SEC into state regulation.

The proposed amendments to the exemptive rules presented a fundamentally different situation. The proposed rules would not merely monitor state regulation but would directly intervene in the emerging regulatory process for VLI.

In addition to the five areas noted above in which the SEC would determine substantial equivalence of state regulation (with the securities laws) prior to application of the exemption, the SEC requested comments on the following additional points which might be added to its "prior approval list."

(1) Protection against unfair contract provisions with respect to redemption;
(2) Protections against insider trading with portfolio securities;
(3) Improper lending of separate account assets to controlling persons;
(4) Prohibitions against breaches of fiduciary duty;
(5) Provision for written advisory contracts;
(6) Prohibitions against certain employees with criminal records serving the insurer's operation of the separate account;
(7) Provision for custodianship of cash and portfolio securities of the separate account and bonding of persons with access;
(8) Provisions on the capacity of the separate account to invest in investment companies, insurance companies, broker-dealers, underwriters, and investment advisory firms;
(9) Provisions for independent review of the operations of the separate account;
(10) Provision for review of separate account financial statements by independent CPA's; and
(11) Private rights of action with respect to such investor protection provisions for contractholders.

According to the SEC, if some or all of these items of prior approval conditions were included in the eventual, amended SEC-VLI exemptions, then VLI would not be exempted from SEC regulations in a state which did not comply with these regulatory conditions authorized by the SEC.

In effect, then, the proposed rules would have mandated the states to regulate – in a certain way – the complex life insurance industry with respect to a new product, according to preconceived notions stemming from a securities-oriented perspective.

The initial NAIC comments on the proposed amendments argued that Congress never envisioned a grant of authority to the SEC that would, in effect, provide it with a veto power over the states, enabling it to impair, supersede or invalidate state insurance laws and regulations.

Beyond discussing the merits of the SEC's so-called relevant areas of investor protection, the NAIC comment made three important points: (1) the test of state regulation should be whether it meets the needs of the public and is likely to prevent reasonably foreseeable abuses not whether it is substantially equivalent to the securities laws designed to attack abuses inherent in a different product; (2) the SEC is less qualified to determine what state regulations should contain than the states; and (3) the solely securities-oriented approach of the SEC is likely to cause it to ignore the inherent product differences which will require a different approach.

At the end of January 1974, the SEC made a further announcement with respect to the proposed amendments to the exemptive rules. The primary announcement of the SEC was the new public hearings were being scheduled to receive additional comments. The SEC highlighted several issues on which they desired further discussion. These issues essentially related to how the SEC prior approval concept would mesh with the state-to-state regulation of VLI.

The NAIC decided not to participate in further oral hearings because the SEC eliminated any right of cross-examination except for itself. The assumed standard in the hearings as to the adequacy of state regulation was to be its equivalence to the alleged protections in the 1940 Act. The forum was considered to be a hostile one where the SEC could examine witnesses in detail on highly technical aspects of the federal securities laws. In short, the NAIC was convinced that there was little to gain through further oral participation.

The NAIC, however, did submit comprehensive written comments on March 11, 1974.

This NAIC statement reiterated the arguments concerning the SEC's lack of jurisdiction to regulate VLI. On the prior approval issue, the NAIC made the point that such a concept would promote intergovernmental conflict in lieu of cooperation between the SEC and the states. Furthermore, it would adversely impact on the ability of the states to flexibly deal with VLI.

In April 1974, the NAIC received a list of questions from the SEC on the prior approval concept and certain technical aspects of the NAIC regulation. On August 14, 1974, a lengthy response was submitted. Following this submission, the SEC never elaborated on the NAIC regulation, the responses provided by the NAIC, the reconciliation of SEC concerns with the regulatory pattern that would be created by the NAIC regulation or the issues surrounding the questions of jurisdiction.

4. Recission of the Exemptive Rules. The SEC announced on February 27, 1975 that it had decided not to adopt the proposed amendments to the exemptive rules. The SEC at the same time announced that it was considering recission of the exemptive rules.

The Commission noted in this release that public response to the proposed amendments was "almost without exception" negative. The SEC concluded that the prior approval procedure would not result in uniformity of oversight, nor adequate investor protections in the relevant areas. Furthermore, said the SEC, the relevant protections could not be afforded without application of the Investment Company and Advisers Acts.

The SEC also issued a companion release on February 27, 1975 that announced its intention to propose a rule to accommodate VLI in the two 1940 Acts.

The proposal to rescind the exemptive rules marked the end of the exemption proceedings initiated nearly five years earlier by the life insurance industry. It also represented a complete reorientation of the Commission on the VLI issue. After the lapse of two years, the Commission was apparently ready to adopt the position recommended by the SEC staff in early 1973 – namely an "approach which would develop specific exemptions from the Investment Company Act rather than provide the total exemption of proposed Rule 3c-4."

On May 30, 1975, the NAIC submitted detailed comments opposing the proposal of the SEC to rescind the general exemptive Rules 3c-4 and 202-1 in favor of new specific exemptive rules. This submission again discussed the lack of SEC jurisdiction with respect to VLI. Although SEC was without authority to regulate VLI – either in terms of oversight, exemptions or active regulation -- the NAIC comments expressed a practical preference for the general exemptive rules as opposed to more detailed regulation by the SEC. Despite the fact that the general exemptive rules could be seen as an unwarranted intrusion into an area **specifically preserved** for state regulation by the McCarran Act, such rules did not contemplate a direct intervention of the SEC into the ongoing process of state regulation. The NAIC argued that the changed stance of the SEC was arbitrary and capricious because no insurer had marketed VLI and no change of circumstances had taken place that would warrant a shift in the SEC's regulatory posture to one of direct regulation. In view of the probability of difficult regulatory conflicts, the NAIC again urged the SEC to recognize its lack of jurisdiction and withdraw from any proposed active regulation of VLI.

Notwithstanding the comments and course of events surrounding the SEC's exercise of jurisdiction over VLI, the SEC announced the recission of the exemptive rules on June 18, 1975.

Shortly following this announcement, the SEC urged the District of Columbia Circuit Court to dismiss the Wellington litigation which had been initiated by the mutual funds in opposition to the exemptive rules. Without a doubt, the original issue was now moot. The NAIC, on the other hand, was faced with the possibility that the jurisdictional issue had been properly joined in that case and that its status as an intervenor could now lead to a judicial review of the still ripe issue of jurisdiction. After review of the matter and on advice of outside counsel, the NAIC chose not to oppose the SEC's motion for dismissal. In short, the reason for rejecting the D.C. Circuit Court was that it was considered to be an inappropriate forum for initial level review of the question of SEC jurisdiction. If the NAIC determined to litigate the jurisdictional issue, the appropriate forum would be a U.S. District Court with a declaratory judgment action. No party or intervenor opposed the dismissal.

D. SEC's Rule 6e-2 for Accommodating VLI Under the 1940 Investment Company Act

On December 30, 1975, the SEC announced its proposed Rule 6e-2. The general framework for the proposed exemptions followed an exemption proposal filed by the Equitable Variable Life Insurance Company in August 1975. The Equitable sought and received specific exemptions from the 1940 Investment Company Act that it determined to be necessary for its marketing of VLI. The SEC order for Equitable had no application beyond the Equitable separate account for VLI and its VLI operation. The proposed Rule 6e-2, however, would be of general application.

On February 18, 1976, the NAIC responded to the SEC's request foı comments on Rules 6e-2 with a brief letter objecting to the SEC's exercise of jurisdiction over VLI. The NAIC urged the Commission to reconsider the materials previously submitted by the NAIC, to withdraw proposed Rule 6e-2 and to refrain from further regulation of VLI. At least two insurance industry groups also submitted comments on proposed Rule 6e-2 which resulted in some revision of Rule 6e-2. On October 31, 1976, the SEC adopted and published its final Rule 6e-2 which became effective November 30, 1976.

As adopted, Rule 6e-2 defines variable life insurance to be a life insurance contract

> subject to regulation under the insurance laws or code of every jurisdiction in which it is offered, funded by a separate account of a life insurer, which contract, so long as payments are duly paid in accordance with its terms, provides for:
>
> (i) a death benefit and cash surrender value which vary to reflect the investment experience of the separate account;
>
> (ii) an initial stated dollar amount of death benefit guaranteed by the life insurer to be at least equal to such stated amount; and
>
> (iii) assumption of the mortality and expense risks thereunder by the life insurer. . . .

Unlike the now rescinded broad exemptive Rules 3c-4, the definition of variable life insurance in Rules 6e-2 is not limited to whole life protection nor does it contain the minimum multiple requirement which relates death benefits and gross premiums. The effect of the new definition would be, if permitted by state law, to allow sales of limited payment and endowment forms of variable life insurance for the nontax-qualified, tax-sheltered annuity and individual retirement account markets.

The principal provisions of the final Rule 6e-2 provide limited exemptions from the Investment Company Act in the areas of management accountability to policyholders, limitations on sales loads and redeemability. The major accountability and concession is the ability of the insurance company in certain circumstances or the state insurance regulatory officials to effectively veto changes in the separate account investment policies directed by policyholder voting. The sales load accommodation allows the 9% sales load -- periodic payment plan limitation -- to be determined over a period of up to 20 years. The sales load formula also includes an allowance of dividends under participating plans. The redemmability accommodation modifies the usual 18-month refund requirement for contracts sold with a "front-end load" by increasing the refund period to 24 months and reducing the amount of excess sales load required to be returned to policyholders. For periodic payment plans, the 1940 Act generally requires the refund of any sales load in excess of 15% for redemptions within 18 months. Under Rule 6e-2, however, refund of the sales load must be made for any loading over 30% for the first contract year plus 10% of payments for the second contract year.

The promulgation of Rule 6e-2 marks the culmination of the SEC's attempt to establish itself as a regulator of a recognized life insurance product. Unlike variable annuities, over which the SEC also has jurisdiction, there has been no attempt by the SEC to break VLI into distinct investment and insurance components. The sales load formula, for example, takes into account and, in most cases, specifies the method for determining allowable charges for each element of the premium including the cost of insurance (1958 CSO Mortality Table) and other charges for mortality and expense risks. Although the Commission purports to deem it impractical to delve into mortality assumptions that go into arriving at mortality and expense charges, it does intend to retain a veto power over excessive fees for mortality and expense guarantees.

Illustrative of the entirely different perspective of the SEC from that of state insurance departments in regulation of variable life insurance is the application of redeemability requirements. Although the 1940 Act requirements are somewhat diluted to accommodate VLI, the issuer must offer to return any sales load in excess of 30% for redemptions in the first contract year and sales charges in excess of an average of 20% at the end of the second contract year. Under the redemption options, the policyholder is entitled to the cash value plus the excess sales load. However, the concepts of pooling of mortality risks and redeemability are fundamentally at odds. The right to surrender a VLI policy for an amount greater than the cash surrender value could enable the purchaser to select against the insurer.

The Guertin Committee of the NAIC which extensively reviewed nonforfeiture benefits in the early 1940's concluded that:

> It should be the objective of the state to establish minimum nonforfeiture benefits on such a basis that continuing policyholders will not be unduly penalized on account of the granting of excessive nonforfeiture benefits to policyholders who terminate their contracts, but the withdrawing policyholders should be granted the largest values which can be granted without violating this condition.

As expressed by the Guertin Committee, the state has an interest in identifying nonforfeiture benefits "as subordinate to the death benefit" and in seeing that they are "not . . . so liberal as to increase the cost of insurance to persisting policyholders or to impair the financial structure" of the insurer.

The SEC's view of redeemability, on the other hand, is tied to the securities law concepts of purchasers surrendering contracts for their proportionate share of issuer's assets. Life insurance policyholders, however, have no proportionate ownership in pooled assets, but rather are entitled only to contractual obligations of the insurer which primarily provide for death benefits and only secondarily include nonforfeiture values. Undoubtedly with SEC regulation, insurers will increase the level of premiums to recoup the cost of the liberal refund benefit. Redeemability would also enhance the investment appeal of the VLI product in direct conflict with the objectives of state insurance regulation.

The accountability requirements of the SEC in regulation of VLI also directly conflict with state insurance regulation. The NAIC Model Variable Life Insurance Regulation makes the insurer's board of directors responsible for all activities of the separate account including selection of investment policies. The SEC, however, requires that policyholders be given voting rights in order to make the insruer's management directly answerable to the VLI policyholder. The operation of the separate account intimately relates to and impacts upon the general account of the insurer. Requiring the insurer to turn over its separate account assets to a manager chosen by the purchasers of variable life insurance while the general assets of the insurer are still at risks, conflicts with the insurance regulator's responsibility to all policyholders of the insurer.

STATEMENT OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Submitted to the
Securities and Exchange Commission
File No. 4-201

Comments Concerning Deferred Annuity Contracts and Proposed SEC Regulation in Response to Securities Act Release No. 5838

By
Maximillian Wallach
District of Columbia Superintendent of Insurance
Chairman, NAIC Variable Life Insurance and
Variable Annuities (C4) Subcommittee

October 6, 1977

These comments are submitted on behalf of the National Association of Insurance Commissioners, commonly referred to as the NAIC. The NAIC is the oldest voluntary association of state officials, and has held regular meetings each year since 1871. Membership of the NAIC includes the chief insurance regulatory officials of the 50 states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands.

On June 22, 1977 the SEC published for comment Securities Act Release No. 5838 requesting comments on the offer and sale of certain annuities and, apparently, announced the SEC's contemplation of subjecting such annuities to federal securities regulation. It is the opinion of the NAIC that for purposes of federal law, the annuities described in Release No. 5838 would be "annuities" within the terms of the 1933 Securities Act and excluded from any inferred securities law authority by McCarran-Ferguson Act (15 U.S.C. 1011-1015). Action taken by the SEC to regulate such annuities would therefore appear to be an unlawful assumption of jurisdiction and an encroachment upon state insurance regulation. The NAIC also notes the failure of the SEC to undertake any efforts to directly advise state insurance regulatory officials of SEC advertising or marketing concerns or indicate possible violations of state or federal law, except by way of SEC Release No. 5838.

I. 1933 ACT EXEMPTION

The articulated purpose of Release No. 5838 is to solicit comments "with respect to the manner in which the contracts under study are similar to or different from traditional fixed annuity contracts . . . ." Congress did not put the insurance business, insurance products, or state insurance regulation into a rigid cast upon enactment of the 1933 Securities Act. The extent to which certain annuity policies, now being reviewed by the SEC, differ from "traditional fixed annuities" is in no way determinative of a security versus insurance determination under the 1933 Securities Act.

The authority of the SEC to regulate so-called "excess interest" annuities or "high interest" annuities, if it exists at all, must arise from the Securities Act of 1933. It is clear from a review of the act, the nature of the described annuities, and the relevant judicial decisions that the 1933 Act does not confer any regulatory authority with respect to such policies. The jurisdictional comments expressed by the SEC staff disregard the inherent distinctions between "insurance contracts" and SEC regulated "securities."

Section 2(1) of the Securities Act of 1933 defines a "security"; Section 3(a)(8) of the Act lists as an "exempt security" "[a]ny insurance . . . policy or annuity contract . . . issued by a corporation subject to the supervision of the insurance commissioner . . . of any State . . . ." (15 U.S.C. 77c(a)(3)). The accompanying House committee report makes it clear that this statutory exemption was in fact unnecessary, that the 1933 Act did not contemplate insurance, and that the redundancy was "to make misinterpretation impossible:"

> Insurance policies are not to be regarded as securities subject to the provisions of the act. The insurance policy and like contracts are not regarded in the commercial world as securities offered to the public for investment purposes. The entire tenor of the act would lead, even without this specific exemption, to the exclusion of insurance policies from the provisions of the act, but the specific exemption is included to make misinterpretation impossible. (H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933)).

For purposes of the 1933 Securities Act, an annuity cannot be a "security" if it is an "insurance or annuity policy."

Release No. 5838 advises that the insurance exemption of the 1933 Act is "not necessarily available to all products labeled insurance policies or annuity contracts" and that the issue is a federal question. We agree that the meaning of "insurance" or "annuity" under federal statutes is a federal question. We do not agree that the SEC can properly label as a "security" anything it wishes. The existence of a federal question does nothing to change the nature of the insurance business, state insurance regulation or the inapplicability of the 1933 Securities Act to insurance products. Regulation of products by the states and insurer activities "in accord with customary practice as policed by state regulatory authorities" are relevant considerations in deciding insurance related federal questions (U.S. v. Consumer Life Insurance Co., U.S., 52L Ed. 2d 4, at 22-23 (1977)).

The description of so-called excess or high interest contracts by the SEC in Release No. 5838 suggests no authoritative criteria that would in any way exempt such policies from state insurance law or subject them to application of the federal securities laws, notwithstanding the Sec. 3(a)(8) exemption of the 1933 Act. Nothing in the release in any way suggests that the policy forms, applications forms, or advertisements lead purchasers to believe that the products are not annuities. There is nothing evidencing a transference of investment risk from the insurer to policyholders.

The staff apparently proceeds to the conclusion that Sec. 3(a)(8) may be inapplicable because the described annuities are "different" than some other annuity forms and sold with some emphasis on the possibility of excess interest or a short term promise of high interest. To this end, the staff cites *SEC v. C.M. Joiner Leasing Corp.* (1943) 320 U.S. 344. *Joiner* noted that the investment element was what "gave to the instruments most of their value and all of their lure" (320 U.S. at 349). However, the primary value and lure of annuities is the guaranteed payment of benefits for life or some specified period of years. The manner of accumulation of funds is an incidental matter in purchasing an annuity. The greatest opportunity for "profit" under any annuity contract is tied to a wholly fortuitous event – living for a period of years in excess of that which is actuarially expected. Annuities are not securities nor are they understood to have a predominantly "investment" character in commerce despite the fact that the accumulation period of a deferred annuity provides, in essence, a means of accumulating a principal sum through the investment facilities of the insurer.

II. NATURE OF THE ANNUITY CONTRACT

Life insurance products of all kinds are now and have always been a means for converting transient income into another form of value. Economic security and protection from the occurrence of some fortutious event is the essence of the insurance-security dichotomy. The available channels for "investment" of personal income are as varied and broad as all financial services existing in the marketplace.

The "investment" or savings features of annuity products are not new or different. In 1940, the SEC recognized that

> Life insurance provides the channel through which millions of American people accumulate savings to gain for themselves . . . a measure of security." (SEC Report, "Study of Legal Reserve Life Insurance Companies," (TNEC Monograph 28, p. 1.))

Premium calculations for annuities provide an aggregate capital fund sufficient to cover longevity losses after allowing for investment and mortality gains. Since reserve funds are held by insurers to meet future policy obligations, life insurance necessarily involves an "investment element" because of the time value of money. Deferred annuities involve an accumulation of net premiums that builds an aggregate of assets for the payment of annuity benefits. These funds, an incident of the insurance function, are invested in media authorized by state insurance regulation.

Annuities marketed on a participating basis have long provided for the payment of dividends during the accumulation period (MAGEE, LIFE INSURANCE, at 67, (3 Ed 1958)). Level premiums, more commonly referred to as deposits, are accumulated at a rate of compound interest specified in the contract. Declarations of excess interest on nonparticipating contracts are in essence little different than declaring participating policy dividends from divisible surplus. Participating life insurance and annuity advertising does and is permitted to publicize that dividends, although not guaranteed, may reduce net premium cost and increase benefits. The logic with which the SEC proceeds in distinguishing so-called "excess interest" annuities from traditional products would, if proper, be equally valid with respect to participating annuities, or life insurance for that matter. The securities laws are, by necessary inference, acknowledged in the release to have no relevance to participating insurance products. Retirement annuities written by mutual insurers are typically participating during the accumulation period and provide for dividends which may be received in cash, applied to future premiums, deposited at interest, or used to purchase paid up additions.

Reserves established for life insurance and annuity contracts represent the difference between the present value of future benefits and the present value of future net premiums. State law prescribes the basis upon which minimum reserves are to be calculated.

This basis is stated in terms of a specified mortality table and the maximum rate of interest to be assumed. As of December 1976, the NAIC Model Standard Valuation and Nonforfeiture Laws specify 5½% for single premium individual deferred annuity contracts and 4½% for all other individual deferred annuities. The interest rate specified in the NAIC models prior to December 1976 was 4% for both single premium and other individual deferred annuities, and this rate may still be applicable in many states. Calculation of premiums using an interest assumption in excess of these rates could result in gross premiums that are less than the valuation net premium used in the calculation of policy reserves. This in turn would necessitate the creation of a deficiency reserve under state law which may be troublesome for smaller insurers with limited available surplus.

Actual or anticipated investment experience on a year to year or other short term basis that exceeds the guaranteed interest factor can be passed on to policyholders in the form of "excess interest" payments without the creation of deficiency reserves if done on a discretionary (not guaranteed for the entire policy term) basis after investment results are in or at a point where they can be accurately predicted. The parallel with participating insurance and dividends is obvious. The staff's fixation with the investment risk borne by the policyholder attributable to the "difference between the low guaranteed rate of interest and the anticipated excess interest" is specious. This policyholder "risk" is, as a practical matter, indistinguishable from the situation existing under a participating contract with the anticipation of dividend declarations. In fact, to the extent that a declaration of excess interest precedes actual investment experience, there is notably less "risk" to policyholders.

The staff's concern with so-called high interest short-term contracts is similarly vexatious. Notwithstanding the fact that the short-term guarantees may be different than "traditional" guarantees in fixed annuity contracts, the guarantees made in the described contracts appear, on the basis of the staff's description, to bind the insurer. Policy guarantees of the sort described would be fully backed by the assets of the insurer. Investment risks are clearly borne by the insurer.

Efforts to describe products with short-term guarantees as securities subject to the federal securities laws appears to be little different than distinguishing endowment policies from other life insurance contracts because of their relatively short-term nature. Release No. 5838 itself acknowledges that a primary element of state insurance regulation is "maintaining the solvency of the insurance companies." No allegation is made that the guarantees may not be fulfilled or that protections afforded to annuity purchasers by state insurance regulation are inadequate for enforcing policy obligations.

Crediting of earnings in excess of guaranteed rates or short-term guarantees at high rates do not change the Section 3(a)(8) "insurance" nature of fixed benefit deferred annuity contracts. There is no investment risk shifting that could even arguably transform these contracts into securities subject to SEC jurisdiction in accordance with the variable annuity decisions. Section 3(a)(8) of the 1933 Act conclusively removes the authority of the SEC to regulate such insurance products.

III. SALES PRACTICES AND STATE REGULATION

Life insurers and policies are subject to rigid regulatory requirements of state insurance law. The principal techniques of state supervision of life insurers include:

(1) company licensing;

(2) financial requirements;

(3) management biographical review;

(4) financial reporting;

(5) examinations of financial condition and market conduct;

(6) application of standard valuation (reserves) and nonforfeiture requirements;

(7) investment limitations;

(8) securities valuation;

(9) agent licensing;

(10) policy provision standards;

(11) rules for complaint practices by insurers and state operated complaint handling services for the public;

(12) marketing controls such as agent licensing standards, policy approval powers and other market controls provided by the broad unfair trade practices laws;

(13) controls over corporate organization;

(14) coordination of state regulatory activities through the NAIC.

State regulatory practices extend far beyond solvency controls. The SEC staff, however, infers that "maintaining the solvency of insurance companies" is virtually the only significant activity of state insurance regulators. The record of state regulation does not even remotely support this naively circumscribed view.

Insurers are subject to revocation of their certificates of authority to do business (and agents to their licenses) if officers, directors, or agents falsely represent the

> benefits, advantages, conditions, or terms of any insurance policy; or . . . the dividends or share of surplus to be received on any insurance policy (NAIC Model Unfair Trade Practices Act, Sec. 4(1)(a) and (b)).

The NAIC Model Unfair Trade Practices Law has been enacted in virtually every state. These laws also prohibit "untrue, deceptive or misleading" statements and violation subjects the insurers and agents to a broad range of remedies and penalties.

It may be of interest to the SEC that the products described in its release are sometimes distributed through broker-dealers. This fact is of little legal consequence, however, since such persons must be licensed by the state as insurance agents, and as such, they are subject to the state insurance laws. Required delivery of an SEC-type prospectus would in fact be counterproductive in alleviating the SEC's alleged concern that such products are marketed as "investments" rather than insurance policies due to the added "investment" indicia lent by the prospectus.

Section 4(2) of the NAIC Model Unfair Trade Practices law prohibits false information and provides statutory authority for regulating advertising, circulars, and any other published material used in promoting policies. The NAIC in 1975 adopted life insurance and annuity advertising rules that provide detailed controls over disclosures and published material used in marketing. A number of states have already adopted these rules and others had similar preexisting authority. The scope of the rules encompasses sales aids, materials and literature of all types. The rules require that advertisements be "truthful and not misleading in fact or implication" (Sec. IV 1).

Any tendency of life insurance or annuity advertising material to mislead or deceive is prohibited. Furthermore, no advertisement shall use the terms

> 'investment,' 'investment plan,' . . . 'profits,' 'profit sharing,' 'interest plan,' . . . or other similar terms in connection with a policy in a context or under such circumstances . . . as to have the capacity or tendency to mislead a purchaser of such policy to believe that he will receive, or that it is possible he will receive, something other than a policy [of insurance] . . . . (Sec. IV 2).

The states have ample authority under these rules to ensure that the use of certain terms in context does not mislead or suggest dominant noninsurance features.

Specifically relating to interest rates and deferred annuities, the NAIC advertising rules were amended in June, 1976 to provide as follows:

For individual deferred annuity products or deposit funds, the following shall apply:

A. Any illustrations or statements containing or based upon interest rates higher than the guaranteed accumulation interest rates shall likewise set forth with equal prominence comparable illustrations or statements containing or based upon the guaranteed accumulation interest rates. Such higher interest rates shall not be greater than those currently being credited by the company unless such higher rates have been publicly declared by the company with an effective date for new issues not more than three months subsequent to the date of declaration.

B. If an advertisement states the net premium accumulation interest rate, whether guaranteed or not, it shall also disclose in close proximity thereto and with equal prominence, the actual relationship between the gross and net premiums.

C. If any contract does not provide a cash surrender benefit prior to commencement of payment of any annuity benefits, any illustrations or statements concerning such contract shall prominently state that cash surrender benefits are not provided.

Appropriate disclosures have become increasingly important because of the effects of inflation and rising interest rates on insurance products.

The advertising rules adopted in 1975 and the NAIC Model Life Insurance Cost Disclosure regulation adopted in 1976 evidence both the awareness and determination of the states to conform insurance marketing practices to consumer needs, given today's economic circumstances. The advertising rules, unfair trade practice laws, policy approval and other broad state insurance regulatory tools provide insurance commissioners full authority to regulate policy content, disclosures and marketing practices of insurers.

In contrast, once the disclosure requirements of the securities laws are complied with, there is little that the SEC can do with respect to the merits of individual securities. According to one former SEC chairman, "the Federal Securities laws do not, and I hope never will, give the Commission power to pass on the merits of securities." (J. Sinclair Armstrong, in remarks to the Investment Bankers Association of America, Nov. 26, 1956). Any representation that the SEC approves or has passed on the merits or truthfulness of individual securities is a felony (15 U.S.C. Sec. 77 w).

As far as the SEC is concerned, quality and safety of stocks, bonds, and other securities is irrelevant. The myopic focus on little read and less often understood SEC-required prospectuses would not enhance regulatory protections afforded the insurance consuming public. The SEC's current concern with fully guaranteed fixed benefit annuities, funded through the insurer's general account, appears to be little more than pure aggrandizement of regulatory authority. Insurance commissioners authority today is far more sophisticated and detailed than the rudimentary status of state regulation in 1933, 1934, and 1940 when Congress explicitly chose to prevent any mistaken application of the securities laws to the insurance business.

Finally, it should be recalled that the McCarran Act (15 U.S.C. 1011-15) bars the SEC from the exercise of authority over the "business of insurance." The McCarran Act is a broad, inclusive reservation to the states of insurance regulatory authority. Until such time as Congress legislates otherwise, insurance regulatory authority is vested for all intents and purposes, exclusively in the states. The public would be better served if the SEC exercised its functions within the framework of its existing statutory authority. To the extent it is free to expend surplus resources in reviewing the insurance business, the states would be receptive to any notice of probable violations of state law recognized by the SEC. Further activities by the SEC are not sanctioned by state or federal law.

IV. CONCLUSION

Neither the "excess interest contracts" nor the "short-term contracts" described by the SEC staff in Securities Act Release No. 5838 appear to have attributes that could validly support purported SEC jurisdiction. The policies described are "annuity contracts" within the meaning of the 1933 Securities Act, subject to the supervision of state insurance authorities. Section 3(a)(8) of the Securities Act and the McCarran-Ferguson Act conclusively preclude SEC regulatory authority. State insurance regulators are actively engaged providing relevant and needed protections to the insurance consuming public. The public is not well served by expansionary tactics of federal agencies seeking to legislate their own jurisdiction at the expense of insurance purchasers who must pay for unnecessary or duplicative regulation.

(C) Committee Technical Task Force
to Review Valuation & Nonforfeiture Value Regulation

to the (C4) Variable Life Insurance and Variable Annuity Subcommittee

This report concerns only the proceedings of the NAIC Technical Task Force to Review Valuation and Nonforfeiture Value Regulation from the June 1977 meeting to the date of this report.

A. Proceedings

This report includes minutes of the June 5, 1977 meeting (Attachment A) and the October 23, 1977 meeting (Attachment B) as well as the report of the technical advisory committee (Attachment C).

The technical advisory committee has prepared a draft of a model nonforfeiture regulation for variable annuities (Attachment C). The technical task force is reviewing this draft and has requested that drafts of conforming changes to the other two sections of the model regulation be prepared.

B. Recommendations

No recommendations are made at this time.

John O. Montgomery, Chairman, California; James Montgomery III, District of Columbia; Larry Gorski, Illinois; Erma Edwards, Nevada; William A. White, New Jersey; Thomas J. Kelly, New York; Ted Becker, Texas; Bradford S. Gile, Wisconsin.

ATTACHMENT A

(C) Committee Technical Task Force
to Review Valuation and Nonforfeiture Value Regulation

Minneapolis, Minnesota
June 5, 1977

The NAIC (C) Committee Technical Task Force to Review Valuation and Nonforfeiture Value Regulation met from 9:00 a.m. until 5:00 p.m. on June 5, 1977 in the Duluth "B" Room of the Radisson Hotel Downtown, Minneapolis, Minnesota.

Present at the meeting were:

For the NAIC Technical Task Force:

John O. Montgomery, Chairman, California
W. Keith Sloan, Arkansas
James R. Montgomery, III, District of Columbia
Larry M. Gorski, Illinois
Erma Edwards, Nevada
Thomas J. Kelly, New York
J. Ramon Estefania, South Carolina
Ted Becker, Texas
Bradford S. Gile, Wisconsin

Representing Technical Advisory Committees to the NAIC Technical Task Force:

(C1) Accident & Health Technical Advisory Committees

Valuation: Peter Thexton, Health Insurance Association of America
Nonforfeiture Values: Ernie Frankovich, Consultant

(C2) Credit Insurance Technical Advisory Committee

Ken Jones, CUNA Mutual
Charles Underwood, Maryland Life

(C4) Variable Products Technical Advisory Committee

Jerome Golden, Equitable Life

Representing the Society of Actuaries Special Committee on Nonforfeiture Value Regulation was Harold B. Leff of Metropolitan Life standing in for Charles Greeley, a member of that special committee.

Representing the Society of Actuaries Special Committee for A New Mortality Table was Paul Ochsner of Guarantee Mutual Life.

Representing the American Council of Life Insurers were Richard V. Minck and John K. Booth.

Representing the National Association of Insurance Brokers was Robert Peter Jeorsch.

Other persons present at this meeting were:

Gregg Carney, Anchor National Life Insurance Co.
Charles H. Buell, Capitol Life Insurance Co.
William M. White, Jr., Connecticut General Life Insurance Co.
Mike Medland, CUNA Mutual Life
Richard M. Stenson and Carl R. Ohman, Equitable Life Assurance Society
Ronald K. Curlee, James B. Milholland and Joseph C. Noback, Milliman and Robertson
David M. Holland, Munich American Reassurance
Blaine Shepherd, Northwestern National Life
Robert M. Chmely, Prudential Insurance Co.
Howard Kayton and David M. Sonderford, Security First Group
Albert Pike, Teachers Insurance and Annuity
Ronald Wolf, Tillinghast, Nelson & Warren
J. Stephen Beckman and H. C. Jaros, United Investors Life

A brief summary of the discussion follows, not in the order of the agenda, but in order by NAIC subcommittee assignments.

For the (C4) Variable Products Subcommittee Report

1. A brief verbal report was given by Jerome Golden, Chairman of the technical advisory committee with respect to variable products. He mentioned three possible alternatives for minimum nonforfeiture values for variable annuities:

   a. The Variable Life Approach – This is comparable to a fixed annuity in that, if you earn a specific interest rate each year, you should get exactly the same nonforfeiture values as for a fixed benefit annuity. There is a problem as to whether or not there should be a limit on asset charges.

   b. The Gross Return Approach – For a given gross return the same benefits should be provided as for fixed annuities. Alternative (a) implied a net return basis for the provision of benefits.

   c. The Defined Deductions Approach – This approach defines deductions from gross considerations as has been done in the model bill for fixed benefit annuities.

   Neither alternative (a) nor alternative (b) take into account the greater handling expense of a variable contract.

It was requested by the NAIC task force that the technical advisory committee elaborate on these proposed approaches giving illustrations where applicable and submit a report for consideration at the next meeting of the task force.

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ATTACHMENT B

(C) Committee Technical Task Force
on Valuation and Nonforfeiture Value Regulation

Boston, Massachusetts
October 22-23, 1977

The NAIC Life, Accident and Health Insurance (C) Committee Technical Task Force on Valuation and Nonforfeiture Value Regulation met on October 22-23, 1977 in the fourth floor conference room of the Boston Regional Office of the Prudential Insurance Company of America.

Present at this meeting were: John O. Montgomery, Chairman, California; W. Keith Sloan, Arkansas; James R. Montgomery III, District of Columbia; Robert J. Callahan and Thomas J. Kelly (Mr. Kelly attended only on October 23), New York; J. Ramon Estefania, South Carolina; Ted Becker, Texas; Bradford S. Gile, Wisconsin.

Members of the task force not attending were: Erma Edwards, Nevada; William White, New Jersey; LaMar Walker, Utah (Mr. Walker announced his resignation in a letter to the Chairman).

Other state insurance department representatives attending were: James H. Hunt, Massachusetts; Eleanor Lewis (as chairperson of the Consumer Advisory Committee), New Jersey; Gloria Jiminez (as a member of the Consumer Advisory Committee), North Carolina.

Representing the Consumer Advisory Committee to the NAIC technical task force were: Eleanor Lewis, PhD, chairperson (liaison member), New Jersey Insurance Department; Daphne Bartlett, FSA (liaison member), Occidental Life Insurance Company of California; Margaret Dahm, retired (U.S. Department of Labor); William DuMouchel, PhD, Mathematics Department, Massachusetts Institute of Technology; Marcia D. Greenberger Esq., Center for Law and Social Policy; Gloria Jiminez Esq. (liaison member), North Carolina Insurance Department; Barbara J. Lautzenheiser, FSA (liaison member), Bankers Life of Nebraska; Alisha Munnell, PhD, Federal Reserve Bank of Boston; Robert A. Sable, National Consumer Law Center.

Members of the Society of Actuaries Special Committee on Nonforfeiture Value Laws present were: Charles Greeley, Metropolitan Life; Tom Eason, Security Mutual of Nebraska; Richard S. Miller, Southwestern Life; William K. Nicol, American National Life (also a member of the Society of Actuaries Committee to Construct a New Mortality Table).

Members of the Accident and Health Insurance Valuation Technical Advisory Committee to the NAIC task force present were: E. Paul Barnhart, Chairman, Consultant; James Olson, Prudential Insurance Company; Peter Thexton, Health Insurance Association of America.

Members of the Credit Insurance Technical Advisory Committee to the NAIC task force present were: William C. Cutlip, Chairman, CUNA Mutual; Harvey Galloway Jr., Nationwide Corporation; Perry Kupferman, Provident Alliance; Andrew Markel, League Life; David Newquist, Occidental Life Insurance Company; Charles Underwood, Maryland Life of Baltimore; G.W. Tolman, American National Insurance Company; Lee Zinzow, Munich American Reassurance Company.

Representing the Variable Product Technical Advisory Committee to the NAIC technical task force was Jerome Golden, Equitable Variable Life.

Representing the American Council of Life Insurance were John K. Booth, Vince Donnelly and Richard Minck.

Representing Teachers Insurance and Annuity Association were Albert Pike, Paul Quinn and Tom Welsh.

Those attending with a special interest in the credit insurance portion of the NAIC task force meeting in addition to members of the Credit Insurance Technical Advisory Committee were: Hugh Alexander, Foremost Life; Charles Bentzin, Bentzin & Associates; James F. Blazek, Maryland Life of Baltimore; R.G. Bucher, Old Republic Life; Jay Jaffe, Jaffe & Associates (under contract with the CCIA); Jim Jerwers, Merit Life Insurance Company; Ken Jones, CUNA Mutual; William P. Ogburn, National Consumer Law Center; James P. Valentine, CCIA; Deborah Williams, Maryland Life of Balitmore.

Other interested persons attending were: Richard Boswell, National Western Life, Texas; Jack Caton, American United Life Insurance Company; John Gardner, Sun Life of Canada; Robert L. Hill, Aetna Life & Casualty; David M. Holland, Munich American Reassurance; Robert Johnson, State Farm Life; Howard Kayton, Security First Group; James Knight, SAFECO Life; Robert A. Miller III, Aetna Life & Casualty; Carl R. Ohman, Equitable Life; Richard M. Stevson, Equitable Life; Ron Wolf, Tillinghast, Nelson & Warren.

The Consumer Advisory Committee is to draft a report to the NAIC technical task force covering:

(1) The reorganization of the Advisory Committee to consider the consumer's interest in all matters covered by the NAIC technical task force, not just sex discrimination;

(2) A proposal for the reimbursement of Consumer Advisory Committee members for travel expense;

(3) The reasons for including as members of the Consumer Advisory Committee only those with no direct relationship with the insurance industry or with insurance regulation.

Under the items relating to the activities of specific NAIC subcommittee comments of members of the Consumer Advisory Committee are included along with comments recorded by those with other interests.

The proposed model regulation submitted by the technical advisory committee was discussed by the task force, and the last paragraph of Section 4 of the proposed Article VII of the model regulation was changed to include wording concerning "a nonprofit corporation under which the contractholder participates fully in the investment, mortality and expense experience of the account."

It was noted that the proposed wording concerns the model regulation NOT the model legislation.

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ATTACHMENT C

To: Technical Task Force to Review
Valuation and Nonforfeiture Values

From: Jerome S. Golden, F.S.A.
Vice President & Actuary
Equitable Variable Life Insurance Company
1285 Avenue of the Americas
New York, New York 10019

Date: September 23, 1977

Re: Proposed Nonforfeiture Regulation for Variable Annuities

At the April and June meetings of the technical task force there was general discussion of the nonforfeiture regulation for variable annuities the advisory committee was developing. At the June meeting I indicated that our committee was considering three alternative approaches which we might present to the task force. Over the summer we were able to settle on one approach which is reflected in the proposal presented as Attachment A. The proposal is titled "Article VII: Nonforfeiture Benefits" since it was drafted to be inserted in the NAIC Model Variable Annuity Regulation (as recognized by the NAIC at the December 1974 meeting). If the approach of modifying the Model Variable Annuity Regulation is adopted, several additional changes to other sections of that regulation would be required.

The general approach of our committee was to follow the Standard Nonforfeiture Law for Individual Deferred Annuities, using the following basic criteria:

> The method of computing minimum nonforfeiture amounts should be such that for a periodic payment variable annuity contract if the net investment return credited to the contract should be equal to 3% per year, then the resulting minimum nonforfeiture amounts should equal the minimum values required by the Standard Nonforfeiture Law for Individual Deferred Annuities for a fixed annuity contract providing for flexible considerations and a 3% interest rate for accumulating net considerations to determine the maturity value.

This general approach produced the following specific recommendations:

1. We did not include a separate definition of minimum nonforfeiture amounts for fixed schedule consideration contracts, since the majority of variable annuity contracts provide for flexible considerations.

2. Rather than specifying a minimum interest rate of 3% to be credited to the minimum nonforfeiture amount, we proposed to refer to the "net investment return" after deductions for asset charges and tax charges, if any, to be credited to the contract. The asset charges under our proposal may not exceed a maximum stated in the contract.

3. We proposed to deviate from the fixed annuity law in permitting an annual contract charge under a paid-up or single premium variable annuity contract. This charge reflects the administrative expenses relating, in part, to the variable nature of the product which continue even though no premiums are being received by the insurer.

There are other minor differences from the fixed annuity law which relate primarily to the variable nature of the product.

There was one question that the committee was unable to resolve before the distribution of our proposal to the task force. It relates to whether the nonforfeiture regulation should be applicable to "fully participating" variable annuity contracts under which mortality and expense results are not guaranteed, such as those offered by College Retirement Equities Fund (CREF). Tom Walsh, Actuary of TIAA-CREF, has prepared an analysis of this question and I am enclosing a copy of his September 21 letter.

Our committee will be represented at the October meeting of your task force and will be available to answer any of your questions.

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Proposed Nonforfeiture Regulation for Variable Annuities

ARTICLE VII: NONFORFEITURE BENEFITS[1]

1. This article shall not apply to any (i) reinsurance, (ii) group annuity contract purchased in connection with one or more retirement plans or plans of deferred compensation established or maintained by or for one or more employers (including partnerships or sole proprietorships), employee organizations, or any combination thereof, other than plans providing individual retirement accounts or individual retirement annuities under Section 408 of the Internal Revenue Code, as now or hereafter amended, (iii) premium deposit fund, (iv) investment annuity, (v) immediate annuity, (vi) deferred annuity contract after annuity payments have commenced, (vii) reversionary annuity, or to any (viii) contract which is to be delivered outside this state through an agent or other representative of the company issuing the contract.

2. To the extent that any variable annuity contract provides benefits which do not vary in accordance with the investment performance of a separate account before the annuity commencement date, such contract shall contain provisions which satisfy the requirements of (the Standard Nonforfeiture Law for Individual Deferred Annuities)[2] and shall not otherwise be subject to this article.

3. In the case of contract issued on or after ____________,[3] no variable annuity contract, except as stated in Paragraphs 1 and 2, shall be delivered or issued for delivery in this state unless it contains in substance the following provisions, or corresponding provisions which in the opinion of the commissioner are at least as favorable to the contractholder, upon cessation of payment of considerations under the contract:

   a. That upon cessation of payment of considerations under a contract, the company will grant a paid-up annuity benefit on a plan described in the contract that complies with Paragraph 6. Such description will include a statement of the mortality table, if any, and guaranteed or assumed interest rates used in calculating annuity payments.

Drafting Notes

1. This section should be included only if the Standard Nonforfeiture Law for Individual Deferred Annuities has been adopted in the particular state.

2. Insert appropriate statutory citation for this law.

3. Insert operative date of this article, which should be at least 18 months after adoption.

b. If a contract provides for a lump sum settlement at maturity, or at any other time, that upon surrender of the contract at or prior to the commencement of any annuity payments, the company will pay in lieu of any paid-up annuity benefit a cash surrender benefit as described in the contract that complies with Paragraph 7. The contract may provide that the company reserves the right, at its option, to defer the determination and payment of any cash surrender benefit 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 determination and payment impractical.

c. A statement that any paid-up annuity, cash surrender or death benefits that may be available under the contract are not less than the minimum benefits required by any statute of the state in which the contract is delivered and an explanation of the manner in which such benefits are altered by the existence of any additional amounts credited by the company to the contract, any indebtedness to the company on the contract or any prior withdrawals from or partial surrenders of the contract.

4. The minimum values as specified in this article of any paid-up annuity, cash surrender or death benefits available under a variable annuity contract shall be based upon minimum nonforfeiture amounts meeting the requirements of this paragraph.

The minimum nonforfeiture amount on any date prior to the annuity commencement date shall be an amount equal to the percentages of net considerations (as specified in Paragraph 5) allocated to the account or accounts funding the contract increased (or decreased) by the net investment return allocated to the percentages of net considerations, which amount shall be reduced to reflect the effect of:

(i) any partial withdrawals from or partial surrenders of the contract,

(ii) the amount of any indebtedness on the contract, including interest due and accrued, and

(iii) an annual contract charge not less than zero and equal to (a) the lesser of thirty dollars ($30.00) and 2% of the end of year contract value less (b) the amount of any annual contract charge deducted from any gross considerations credited to the contract during such contract year.

"Net investment return" means the rate of investment return to be credited to the variable annuity contract in accordance with the terms of the contract after deductions for tax charges, if any, and for asset charges either at a rate not in excess of that stated in the contract, or in the case of a contract issued by a nonprofit corporation under which the contractholder participates fully in the investment, mortality and expense experience of the account, in an amount not in excess of the actual expense not offset by other deductions. The net investment return to be credited to a contract shall be determined at least monthly.

5. The percentages of net considerations used to define the minimum nonforfeiture amount in Paragraph 4 shall meet the requirements of this paragraph.

a. With respect to contracts providing for periodic considerations, the net considerations for a given contract year used to define the minimum nonforfeiture amount shall be an amount not less than zero and shall be equal to the corresponding gross considerations credited to the contract during that contract year less an annual contract charge of thirty dollars ($30.00) and less a collection charge of one dollar and twenty-five cents ($1.25) per consideration credited to the contract during that contract year. The percentages of net considerations shall be sixty-five percent (65%) for the first contract year and eighty-seven and one-half percent (87-1/2%) for the second and later contract years. Notwithstanding the provisions of the preceding sentence, the percentage shall be sixty-five percent (65%) of the portion of the total net consideration for any renewal contract year which exceeds by not more than two times the sum of those portions of the net considerations in all prior contract years for which the percentage was sixty-five percent (65%).

b. With respect to contracts providing for a single consideration, the net consideration used to define the minimum nonforfeiture amount shall be the gross consideration less a contract charge of seventy-five dollars ($75.00) and the percentage of the net consideration shall be ninety percent (90%).

6. Any paid-up annuity benefit available under a variable annuity contract shall be such that its present value on the annuity commencement date is at least equal to the minimum nonforfeiture amount on that date. Such present value shall be computed using the mortality table, if any, and the guaranteed or assumed interest rates used in calculating the annuity payments.

7. For variable annuity contracts which provide cash surrender benefits, the cash surrender benefit at any time prior to the annuity commencement date shall not be less than the minimum nonforfeiture amount next computed after the request for surrender is received by the company. The death benefit under such contracts shall be at least equal to the cash surrender benefit.

8. Any variable annuity contract which does not provide cash surrender benefits or does not provide death benefits at least equal to the minimum nonforfeiture amount prior to the annuity commencement date shall include a statement in a prominent place in the contract that such benefits are not provided.

9. Notwithstanding the requirements of this article, a variable annuity contract may provide under the situations specified in a or b below that the company, at its option, may cancel the annuity and pay the contractholder its accumulated value and by such payment be released of any further obligation under such contract:

    a. if at the time the annuity becomes payable the accumulated value is less than $2,000, or would provide an income the initial amount of which is less than $20 per month; or

    b. if prior to the time the annuity becomes payable under a periodic payment variable annuity contract no considerations have been received under the contract for a period of two (2) full years and the total consideration paid prior to such period amounted to less than $2,000.

10. For any variable annuity contract which provides, within the same contract by rider or supplemental contract provision, both annuity benefits and life insurance benefits that are in excess of the greater of cash surrender benefits for a return of the gross considerations with interest, the minimum nonforfeiture benefits shall be equal to the sum of the minimum nonforfeiture benefits for the annuity portion and the minimum nonforfeiture benefits, if any, for the life insurance portion computed as if each portion were a separate contract. Notwithstanding the provisions of Paragraph 4, additional benefits payable (a) in the event of total and permanent disability, (b) as reversionary annuity or deferred reversionary annuity benefits, or (c) as other policy benefits additional to life insurance, endowment, and annuity benefits, and considerations for all such additional benefits, shall be disregarded in ascertaining the minimum nonforfeiture amounts, paid-up annuity, cash surrender and death benefits that may be required by this article. The inclusion of such additional benefits shall not be required in any paid-up benefits, unless such additional benefits separately would require minimum nonforfeiture amounts, paid-up annuity, cash surrender and death benefits.

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To: Mr. Jerome S. Golden, F.S.A.
Vice President & Actuary
Equitable Variable Life Insurance Company

From: Teachers Insurance and Annuity Association of America
College Retirement Equities Fund
730 Third Avenue
New York, New York 10017

Date: September 21, 1977

Re: Exemption of Fully Participating Contracts
From Nonforfeiture Regulations

The variable annuity was originally conceived by College Retirement Equities Fund (CREF) and the first of such contracts was issued by that organization in July 1952. As originally devised and in all of the variable annuities written by CREF thereafter, the contract is <u>fully participating</u> on the part of each contractholder.

The variable annuity was developed by CREF after extensive economic studies showing that if, in the past, a portion of annuitants' retirement accumulations had participated fully in a broad-based common stock portfolio, this participation, in addition to a fixed income annuity would have provided combined fixed and variable annuity income which gave better purchasing power protection than fixed income annuities alone. CREF devised the necessary actuarial formulae for writing variable annuities utilizing the fully participating contract. From its inception, CREF was the only major source of variable annuities during the 1950's and early 1960's and in the interim, has written some 500,000 of these contracts. Many other companies now write variable annuities, but CREF is undoubtedly the largest issuer of individual variable annuities.

CREF is a New York membership corporation established more than 25 years ago for the singular purpose of providing retirement benefits through variable annuity contracts exclusively for the employees of colleges, universities, independent schools and other eligible tax-exempt educational institutions. It is a companion organization to Teachers Insurance and Annuity Association of America (TIAA) whose primary purpose is to provide retirement benefits through fixed income annuity contracts exclusively for the employees of colleges, universities, independent schools and other eligible tax-exempt educational institutions. The two organizations are nonprofit service organizations organized for the purpose of aiding tax-exempt educational institutions in the funding of retirement benefits for their employees. The national pension program of TIAA-CREF, providing these combined fixed and variable retirement annuity benefits, presently serves some 3,000 eligible institutions. The TIAA-CREF retirement system is an integral part of higher education and provides fully funded, fully vested retirement benefits through individually owned contracts, thereby permitting necessary academic mobility of faculty members from one institution to another without impairing the ownership and accumulation of the retirement funds credited to their accounts. All TIAA-CREF services are provided only through full-time salaried employees and are not available to the general public.

The CREF contract is fully participating for the benefit of the contractholder, one of its unique and essential features. The contractholder participates fully not only in the investment results of the fund but also in the fund's expense and, during their retirement years, in mortality experience. Annuitants receiving benefits participate in all three elements – investment, mortality and expenses. Those still in the accumulation stage do not participate in mortality experience until their benefits begin. Since there is full and current participation in CREF's expense, mortality and investment results, CREF need not and does not assess the charges otherwise required to make guarantees or to fund reserves securing such guarantees. It should also be noted, in view of the long-term pension character of the CREF retirement annuity (encompassing up to 40 working and 15 to 20 or more retirement years) that any guarantee of expense charges or mortality rates would require sufficiently conservative reserving to assume their fulfillment 40 or 50 years in the future. Instead of siphoning off any of CREF's current experience for such reserve, the CREF contract provides for participation fully and on a current basis in the actual expense, mortality and investment experience of the fund. Expense and mortality levels are set at their actual levels and any difference between these levels and the actual experience in any year is treated in the same manner as investment experience, and thereupon reflected in the individual's account for that year. Under this fully participating approach, there are no deductions from the accounts for other than the current level of expenses and the current level of mortality. No contingency reserves are established and there is no determination of gains or losses each year nor a dividend determination to be made and distributed. This is equity, as complete and current for the individual consumer, as actuarial science can make it.

Variable annuities are now offered by many companies but none of their contracts are written on this fully participating basis. All other variable annuity contracts specify expense charges and mortality rates that cannot be changed in the future. As a consideration for such guarantees, the companies have been obliged to assess various underwriting or risk charges which often exceed 1/2 of 1% each year of the assets supporting an individual's account, both before and after commencement of retirement income. The effect of this charge on an individual's accumulation can be substantial. For example, a charge of 1/2% per year upon a single premium of $1,000 accumulated at 7% a year results in a total charge of $348 after 20 years; or a charge of $990 after 30 years. By comparison, CREF's fully participating charge against assets has averaged about 1/10 of 1% of assets.

In summary, a fully participating variable annuity provides the contractholder with certain advantages over those variable annuities that must guarantee expense charges and mortality rates far into the future:

1. There is no underwriting or risk charge assessed annually against each individual account to protect guarantees, and therefore to that extent a higher rate of return is provided on the account each year, both during the accumulation and retirement periods.

2. The level of expenses deducted is lower since it is based solely on current actual expenses without the need for any margin of safety against future increases. Furthermore, under a fully participating variable annuity, any excess of actual loading over actual expenses incurred is returned currently to the contractholder.

3. At the time of retirement, benefits are determined based upon fund annuitants' current level of mortality, without margin for anticipated and unanticipated future mortality improvements. Subsequent changes in mortality improvement will thereafter be immediately and fully reflected in the recalculation of the annuity unit value.

The history of CREF is the history of the variable annuity in the fully participating form. It is a 25-year history of continuous benefits and service to educational institutions and their employees. Although the contractholder participates fully in current expenses, the corporate purpose of CREF has been to keep such costs as low as possible. The actual CREF expense charges during the last 25 years are shown in the following chart. These charges are shown as a percentage of premiums, a percentage of annuity benefit payments, and as a percentage of assets. The loadings on premiums and annuity benefit payments reflect the level of administrative expenses for the fund during these years and the charge as a percentage of assets reflects the level of investment expense during these years. It should be noted that in recent years, this investment expense charge has averaged less than 1/10 of 1% of assets. This history demonstrates that the fully participating nature of the CREF variable annuity produces substantially lower charges than variable annuity contracts which must make and fulfill long-term guarantees.

25 Year History of CREF Operating and Investment Expense Charges

From	To	% of Premiums	% of Annuity Payments	% of Assets
7/52	12/57	4	1	.25
1/58	12/59	3	1	.25
1/60	12/61	2.1	1	.20
1/62	3/62	2	1	.15
4/62	12/63	2	1.3	.15
1/64	12/64	1.8	1.3	.10
1/65	12/65	1.8	1.3	.07
1/66	3/67	1	1.3	.05
4/67	3/68	1	1.3	.05
4/68	3/69	1	1.3	.14
4/69	3/70	1	1.3	.14
4/70	3/71	1.3	1.3	.11
4/71	3/72	1.5	1.5	.06
4/72	3/73	1.5	1.5	.03
4/73	3/74	1.5	1.5	.07
4/74	3/75	1.5	1.5	.13
4/75	3/76	1.75	1.5	.11
4/76	3/77	1.75	1.5	.08

On the basis of this 25-year history, we believe the fully participatory format of the first variable annuity, as originally conceived and perpetuated during that period, should be permitted to continue. This contract has proven to be of inestimable benefit to the college world in providng retirement benefits for their employees.

We strongly recommend therefore that an exemption be granted for the original and only fully participating variable annuity. Otherwise, any limitation upon expenses will preclude, without cause or reason, the fully participating aspect of the CREF contract, which has never previously been challenged for any reason and which gives the individual consumer as great and current equity as actuarial science can provide. In such event, the elimination of the fully participating feature would be as fundamental and radical a change in the CREF operations as would be a guarantee of or limitation upon investment income under any other variable annuity. Another basis for exemption of CREF's fully participating variable annuity is the analogy with the basis for exempting group annuities in the model regulation. This latter exemption was granted because group contracts are issued to employers who are not deemed to require the same protection as individual purchasers of annuities. The TIAA-CREF national pension system is intended to serve institutional employers in basically the same manner as group annuities. Although individual CREF certificates provide all of the incidents of individual ownership necessary to provide full and immediate vesting and portability, they are issued in connection with an employer's pension plan. These institutional purchasers have all or more of the sophistication as do the purchasers of group annuities. Furthermore, the CREF program is similar in all respects (except for individual ownership of benefits) to that of retirement plans funded through group annuities.

For these reasons, we reiterate the need for exemption from nonforfeiture laws or regulations for the fully participating variable annuity.