

HB

872

Cross-referenced

MEMORANDUM IN SUPPORT OF H.B. 872

This bill would modernize the Standard Valuation and Nonforfeiture Laws (1) to add a new nonforfeiture law for individual deferred annuities, *p. 10-16* (2) to increase statutory interest rate assumptions in the Standard Valuation and Nonforfeiture Laws for newly purchased life insurance and annuities to reflect changes in the level of life insurance company interest earnings that have occurred since the law was last updated and to reflect the uses of particular statutory interest assumptions, (3) to increase the maximum permissible age setback for females in the Standard Valuation and Nonforfeiture Laws for life insurance from three years to six years, *p. 1, 5, 6, 7, 8 and 9* (4) to define the Commissioners Annuity Reserve Valuation Method, (5) to modify the Commissioners Reserve Valuation Method for policies under which the gross premium actually payable is less than the valuation net premium and (6) to replace the mortality tables used for valuing annuities *p. 2, 8* with new tables reflecting changes in annuitant mortality. The bill is part *p. 7-8* of a nationwide program adopted by the National Association of Insurance Commissioners. *p. 5-6* *p. 6-7*

The Standard Nonforfeiture Law for Individual Deferred Annuities

sets forth the minimum nonforfeiture values that must be made available as paid-up annuity or, if applicable, cash surrender benefits to individual deferred annuity contract purchasers who cease paying considerations prior to maturity of their contracts. For many years, only a handful of states have had annuity nonforfeiture laws which approximated these minimum requirements. Recent rises in interest earnings that insurers are able to credit on individual deferred annuities and favorable tax treatment under the Employee Retirement Income Security Act of 1974 have stimulated sales of individual deferred annuities and created a much greater need for standard legislation to establish minimum nonforfeiture values for these products. The bill would enact the NAIC Standard Nonforfeiture Law for Individual Deferred Annuities in the Standard Valuation and Nonforfeiture Laws.

Increase in Statutory Interest Assumptions in the Standard Valuation and Nonforfeiture Laws for Newly Purchased Life Insurance and Annuities

The Standard Valuation Law sets forth the minimum reserves that an insurance company must maintain for a block of business. The need for keeping this law up-to-date is most dramatically illustrated in the case of single premium immediate individual annuities and group annuities. In order to be competitive, companies set the purchase price for such annuities using the current rate of return that they obtain from new investments. The average yield on new fixed-income investments by 60 life

insurance companies accounting for about 65% of life insurance company assets was 9.08% in 1974, 9.87% in 1975, and 9.73% in 1976. The current law, however, requires companies to set up reserves considerably in excess of the funds actually received as premiums for annuities because the valuation law prescribes a 3 1/2% interest rate to be used to compute minimum reserves. Unless this rate is changed, companies will be faced with the alternative of either increasing the premiums charged for annuities or limiting or stopping the sale of annuities.

The effect of requiring reserves to be established on an unrealistically low valuation interest rate can be illustrated by the following example: Suppose a company agrees to guarantee the payment of \$1000 at the end of one year in return for the payment of a specified premium at the beginning of the year. If the company is able to invest the premiums received to yield 9%, it only has to charge $\$1000 + 1.09$ or \$917.43 as the premium. But the current valuation law requires the reserves to be established on the assumption that the investments will yield only 3 1/2%, rather than the 9% at which the funds are actually invested. This requires a reserve in the amount of $\$1000 + 1.035$ or \$966.18, which is \$48.75 more than the actual premium received. This difference can only be taken out of the company's surplus.

Since most annuities continue in force for more than one year after the premium is received, the effect of the difference between the actual

interest rate earned and the statutory interest rate assumption produces an even greater drain on surplus. An example of the surplus drain caused by requiring overly conservative reserve interest assumptions in the face of higher investment yields and competitive pricing can be illustrated by a comparison of net single premiums for a life annuity of \$100 per month to a male aged 65 computed on the basis of the 1971 Group Annuity Mortality Table and an interest rate close to what insurers are currently using to price group annuities with the statutory reserve requirements. The net single premium for such an annuity calculated on the basis of the 1971 GAM and 9% interest, which is representative of interest rates currently used in determining group annuity benefits, is \$9,205. However, the required reserves for this annuity calculated on the basis of the current minimum reserve basis of 3 1/2% interest and the Group Annuity Mortality Table for 1951 is \$12,760 or 39% more than the net premium used in pricing the benefit.

A similar calculation can be made for a life annuity of \$100 per month commencing at age 65 for a male now aged 55, which is a typical weighted average age in the case of annuities sold to fund terminating pension plans. In this case the net premium based on 9% interest and the 71 GAM Table is \$3,409 while the required reserve based on 3 1/2% interest and the Group Annuity Mortality Table for 1951 is \$7,740. Thus, an additional 127% above the net premium used in pricing the benefit must be established as reserves. Similar surplus drains arise from the sale of other life insurance and annuity products but are not as extreme because prices for these products reflect both current and expected future yields on life insurer's investments.

To reduce drains in surplus and to give life insurance companies the flexibility to offer lower priced products with lower nonforfeiture values and reserves, the bill would increase the statutory valuation interest rate assumptions for group annuities and for single premium individual immediate annuities from 3 1/2% to 7 1/2%, for single premium life insurance and for single premium individual deferred annuity contracts from 3 1/2% to 5 1/2% and for all other life insurance policies and all other individual deferred annuity contracts from 3 1/2% to 4 1/2%, and would increase the statutory nonforfeiture interest rate assumptions for single premium life and endowment insurance from 3 1/2% to 6 1/2% and for all life insurance from 3 1/2% to 5 1/2%. The statutory valuation interest rate assumptions vary depending upon the type of product with which they are used so as to reflect the degree of investment risk and hence the need for greater or lesser conservatism in minimum reserve standards. The statutory nonforfeiture interest rate assumptions are higher than the statutory valuation interest rate assumptions since the Standard Nonforfeiture Law is not a solvency test and minimum nonforfeiture standards should be based upon interest assumptions that are closer to those used in product pricing.

(B) p. 6, 7
 (C) p. 1, 6
 (D) p. 1, 6
 (E) p. 8, 9
 (F) p. 8, 9
 (B) (C)
 (D) (E)
 (G) p. 5 and (C), (D), (E) and (F)

Increase in Maximum Permissible Age Setback For Females

The bill would recognize the increase in longevity of women relative to that of men by increasing the maximum permissible age setback used in calculating life insurance minimum nonforfeiture values and reserves from three to six years. As with the increase in statutory interest rate assumptions, such an increase in the maximum permissible age setback would give insurers the flexibility to offer women lower priced life insurance products with lower nonforfeiture values and reserves.

(H) p. 2, 8

Definition of the Commissioners Annuity Reserve Valuation Method

(I) p.7
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The Commissioners Reserve Valuation Method is that portion of the Standard Valuation Law which describes the procedure for computing minimum reserve standards using the statutory valuation interest rate and mortality assumptions. The application of this method to annuity contracts has never been clearly defined with the result that some insurers have failed to take into account all promised contractual benefits in calculating minimum reserve standards for some types of individual deferred annuity contracts and have not established adequate reserves for these benefits. The bill adds a definition of the Commissioners Annuity Reserve Valuation Method to the Standard Valuation Law to clarify the procedure to be used in calculating minimum reserve standards for individual deferred annuity contracts.

Modification of the Commissioners Reserve Valuation Method For Policies Under Which the Gross Premium Is Less Than the Valuation Net Premium

(J) p.5-6

The Standard Valuation Law requires an insurer to establish additional reserves called "deficiency reserves" whenever the gross premium actually payable under a policy is less than the valuation net premium used in computing the policy reserve. The effect of this requirement is to force insurers to hold larger deficiency reserves if they choose to strengthen basic policy reserves. The combined increase in both basic policy reserves and deficiency reserves may deter many companies from strengthening reserves when it would be appropriate. The bill would modify the commissioners reserve valuation method to make it possible for companies to strengthen basic policy reserves without having to hold higher deficiency

New Mortality Tables

(K) p.6,7

Concurrently with increasing the interest rates in the Standard Laws, the bill would require companies to use the new 1971 Individual and Group Annuity Mortality Tables in place of the older 1937 Standard Annuity Mortality Table, the Annuity Mortality Table for 1949, and the Group Annuity Mortality Table for 1951.

Nationwide Program

These proposed changes were approved by the National Association of Insurance Commissioners at its meetings in December 1972 and December 1976 for nationwide enactment. All of the states except Maryland have adopted the 1972 changes. Twelve states adopted the 1976 changes in 1977 and it is probable that additional states will act in 1978. If this legislation is not enacted in Alaska, lower cost life insurance policies will not be available in Alaska, and Alaska citizens will not have the protection of the new nonforfeiture law for individual deferred annuities.

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