

**STATE OF CALIFORNIA  
DEPARTMENT OF INSURANCE  
45 Fremont Street, 24<sup>th</sup> Floor  
San Francisco, California 94105**

**INITIAL STATEMENT OF REASONS**

**ANNUITY NONFORFEITURE REGULATIONS**

**Date: February 6, 2012**

**REG-2007-00039**

**INTRODUCTION**

The Insurance Commissioner proposes to add to Title 10, Chapter 5, Subchapter 3 of the California Code of Regulations (“CCR”) the new Article 10.2, titled “Annuity Nonforfeiture,” consisting of Sections 2523, 2523.1, 2523.2, 2523.3, 2523.4, 2523.5, and 2523.6.

Existing California Insurance Code Section 10168.25 is derived from and based upon a National Association of Insurance Commissioners (“NAIC”) Model law, the Standard Nonforfeiture Law for Individual Deferred Annuities, NAIC Model # 805. The purpose of Insurance Code Section 10168.25 is to regulate annuity nonforfeiture amounts. In general terms this means that any paid-up annuity, cash surrender, or death benefits available under an annuity contract subject to the statute must have a certain minimum value, which serves to protect consumers who purchase these products. The statute sets forth requirements for calculating minimum nonforfeiture amounts for annuities and for documenting the calculations for the Commissioner. The statute contains provisions applicable to annuities with equity indexed benefits as well as to annuities without equity indexed benefits. Subsection 10168.25(f) authorizes the Commissioner to adopt regulations to implement the statute, as does Insurance Code Section 10168.92.

After the NAIC adopted NAIC Model # 805, it adopted Annuity Nonforfeiture Model Regulation, NAIC Model # 806 (“NAIC Model # 806” or “the Model”). The purpose of NAIC Model # 806 is to implement, interpret and make specific the requirements of Section 4 of the Standard Nonforfeiture Law for Individual Deferred Annuities, NAIC Model # 805. NAIC Model # 806 establishes more specific rules for calculating minimum nonforfeiture amounts for annuities subject to NAIC Model # 805 and for providing documentation of the calculations to the Commissioner.

The Commissioner now proposes to adopt the provisions of NAIC Model # 806 (with some modifications) to implement, interpret, and make specific the provisions of Insurance Code Section 10168.25.

## **DESCRIPTION OF THE PUBLIC PROBLEM**

Insurance Code Section 10168.25 sets forth general requirements but it does not address, and it was never intended to address, a number of issues that have arisen in the implementation of the statute. These issues are addressed in the proposed regulations.

Insurance Code Section 10168.25 provides that the minimum values of any paid-up annuity, cash surrender, or death benefits available under an annuity contract subject to that section must be calculated based on the minimum nonforfeiture amounts as defined in Section 10168.25. The statute contains terms which are not fully defined and which could be interpreted in more than one way, for example terms such as “basis” and “equity indexed benefit.” The statute does not specify whether or not the method used to calculate the nonforfeiture rate at contract issue must be filed with the Commissioner, or whether or not this “initial method” can be changed for new contracts issued, or whether or not this “initial method” or the “redetermination method” as defined in the proposed regulations must be disclosed in the contract. In addition, if the nonforfeiture rate is to be redetermined, the statute does not specify whether changes to this “redetermination method” are allowed for new contracts issued.

Although the statute permits an additional reduction of up to 100 basis points in the calculation of the nonforfeiture interest rate for annuity contracts which provide substantive participation in an equity indexed benefit, it does not explain what constitutes “substantive participation.” The statute requires that the present value of the additional reduction shall not exceed the market value of the equity indexed benefit, and that the Commissioner may require a demonstration of this, but it does not provide any guidance on how to calculate the market value of the benefit or guidance as to whether or not the insurer should prepare a demonstration for the Commissioner. The statute also specifies that “lacking a demonstration that is acceptable” the Commissioner may disallow or limit the additional reduction, but it does not specify what would be considered a demonstration that is acceptable. It also does not detail whether or how insurers should certify that their calculations are in compliance with applicable law. The statute is silent on the extent to which insurers should maintain their work papers and it does not detail the Commissioner’s options if the Commissioner determines that an additional reduction of up to 100 basis points for equity-indexed benefits has been inappropriately taken. Finally, the statute provides no examples or illustrations of how its provisions should be implemented.

Because Insurance Code Section 10168.25 sets forth general requirements that can be interpreted in more than one way, insurers could calculate nonforfeiture interest rates in various ways and they might not always provide sufficient detail to explain their calculations. In addition, they have sometimes been uncertain how to provide a suitable demonstration to support the additional reduction permitted by Insurance Code Section 10168.25(e).

The purpose of the proposed regulations is to implement, interpret, and make specific the requirements of Insurance Code Section 10168.25 so that the statute is interpreted and applied clearly and uniformly as set forth in more detail below. The proposed regulations are reasonably necessary to make the general provisions of Insurance Code Section 10168.25 more specific and to carry out its purpose in regulating annuity nonforfeiture amounts. The problem addressed by the proposed regulations is one of clarity and uniformity.

The Commissioner anticipates that the benefit of adopting the proposed regulations will be increased certainty, clarity, and uniformity in the implementation of Insurance Code Section 10168.25. Specifically, the Commissioner anticipates that adoption of the proposed regulations will promote uniformity with NAIC Model # 806 and with that of the law of any other state that adopts the provisions of the Model; foster a more uniform implementation of Section 10168.25; promote fairness and increased clarity in that insurers making the calculations required by Insurance Code Section 10168.25 will know what is expected under the statute; promote more transparency in government in that insurers will have more specific information on what they need to provide to the Commissioner; and increase efficiency in the preparation of documents that must comply with Section 10168.25. In addition, NAIC Model # 806 and the Commissioner's adoption of the proposed regulations reflect advances in regulatory law as developed by the NAIC. The proposed regulations also protect consumers because they help to ensure that annuities subject to Insurance Code Section 10168.25 comply with the nonforfeiture requirements of the statute, which is beneficial to the welfare of California residents.

For the most part, the text of the proposed regulations follows the language of NAIC Model # 806, with only nonsubstantive changes in grammar, format, and numbering. In instances where substantive language has been added or deleted, in each case identified and discussed separately below, the changes were necessary in order to comply with or avoid conflict with California law, to avoid redundancy, and/or to clarify the meaning of the proposed regulations.

The Commissioner has determined that the adoption of regulations that follow the language of NAIC Model # 806 is the most beneficial and effective way to address the problems that have arisen in implementing Section 10168.25.

The NAIC is an organization comprised of the chief insurance regulatory officials from all 50 states, the District of Columbia, and five U.S. territories. One of the NAIC's many activities is to assist regulators with financial and market conduct regulation by fostering the development of NAIC model regulations. Individual states incorporate provisions of NAIC model regulations into their own laws to promote uniformity between the states and to incorporate new developments in insurance industry regulation into their own regulations.

It can be beneficial to both insurers and consumers when administrative costs related to compliance with multiple, inconsistent regulatory requirements imposed by different states are reduced. The proposed regulations tend to serve this purpose by ensuring that California's regulatory requirements in this area are as consistent with those of a national model, and with those of other states that have adopted NAIC Model # 806, as is possible under California law. Both insurers and consumers stand to benefit when insurers are able to devote additional resources — resources which would otherwise be devoted to satisfying multiple, inconsistent regulatory regimes — to improving their financial stability or providing better products to consumers. The proposed regulations are reasonably necessary to further this goal.

## **SPECIFIC PURPOSE AND REASONABLE NECESSITY FOR THE REGULATIONS**

This portion of the Initial Statement of Reasons sets forth the specific purpose of each proposed regulation and the rationale for the Commissioner’s determination that each regulation is reasonably necessary to carry out the purpose of Section 10168.25.

The sections and subsections of the proposed regulations are numbered and lettered differently from the corresponding NAIC Model # 806 sections so that the proposed regulations fit into the numerical and letter sequence of the California Code of Regulations.

The Commissioner has determined that it is not necessary to include two sections of NAIC Model # 806 in the proposed regulations. It is not necessary to adopt the first section of NAIC Model # 806, titled “Authority,” which sets forth the rulemaking authority for the proposed regulations. The rulemaking authority for each section of the proposed regulations is set forth in the “Note” below each section of the proposed regulations as required by Government Code Section 11346.2(a)(2). In addition, it is not necessary to adopt the last section of NAIC Model # 806, titled “Effective Date,” which would set forth the effective date for the proposed regulations. The effective date for the proposed regulations will be determined pursuant to Government Code Section 11343.4 based on the date the regulations are filed with the Office of the Secretary of State.

### **Section 2523. Purpose**

Section 2523 provides that the purpose of Article 10.2, which sets forth the proposed regulations, is to implement, interpret, and make specific the provisions of Section 10168.25 of the Insurance Code. Section 10168.25 governs minimum nonforfeiture values for annuities that are subject to that section. The purpose of Section 2523 is to identify and clarify the purpose of the regulations and the provisions of the Insurance Code being implemented, interpreted, and made more specific. Section 2523 is reasonably necessary for purposes of clarity, because it identifies the regulations, the purpose of the regulations, and the section of the Insurance Code that they implement, interpret, and make more specific. Proposed Section 2523 along with the following proposed regulations address the specificity, clarity, and uniformity problems that arise in the implementation of Section 10168.25.

The language of Section 2523 is substantially the same as the language of Section 2 of NAIC Model # 806. To the extent the language of Section 2523 diverges from that of Section 2 it does so to conform the language of the Model to California law and to the format and terminology used in the California Code of Regulations. Specifically, the word “Article” has been substituted for “regulation,” the phrasing “to adopt rules to implement” has been replaced with “to implement, interpret, and make specific” in order to be consistent with the language of California Government Code Section 11342.600, and a citation to California Insurance Code Section 10168.25 and a general description of the section have been inserted in place of a reference to Section 4 of the Standard Nonforfeiture Law for Individual Deferred Annuities.

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### **Section 2532.1. Definitions**

The purpose of this section is to define terms used in Insurance Code Section 10168.25 or the proposed regulations or both. It defines the words “basis,” “equity-indexed benefits,” “index term,” “initial method,” “initial nonforfeiture rate,” “minimum nonforfeiture amount,” “nonforfeiture rate,” “redetermination method,” and “redetermination nonforfeiture rate” for purposes of clarity, so that a reader of the proposed regulations can understand exactly what is meant by these terms. This section is reasonably necessary to eliminate any confusion as to what is meant by these terms so that the statute can be implemented, interpreted, and made specific in a manner that is clear, uniform, and understandable. Proposed Section 2523.1 addresses the specificity, clarity, and uniformity problems that arise in the implementation of Section 10168.25 by defining terms that are either used in the statute but not defined, or used in the regulations in order to implement, interpret, and clarify the statute. The Commissioner anticipates that proposed Section 2523.1 will be beneficial because it will clarify terms used in Insurance Code Section 10168.25 and/or the proposed regulations so that they can be understood and implemented in a uniform manner.

The purpose of Subsection 2523.1(a) is to define and clarify the meaning of “basis” as that term is used in both Section 10168.25 and the proposed regulations. The word “basis” can have more than one meaning, depending upon the context in which it is used. Although Subsection 10168.25(d)(2) defines the term “basis,” it is defined only in the context of nonforfeiture interest rate redetermination. The definition of “basis” in proposed Subsection 2523.1(a) clarifies that the definition of “basis” has two meanings for purposes of implementing the statute: one when used in the context of an initial or redetermination method (Subsection 2523.1(a)(1)) and the other when used in the context of equity-indexed benefits (Subsection 2523.1(a)(2)).

Subsection 2523.1(a)(1) clarifies that the specified period can be as short as a single day. Subsection 2523.1(a)(1) also clarifies that the same basis shall apply to all equity-indexed benefits and the non equity-indexed benefit, if any.

Subsection 2523.1(a)(1)(A) clarifies that the basis may use a specified period that is determined by the level of change in the CMT rate, or any other date dependent methodology adopted by the NAIC and approved by the Commissioner. However, the insurer may not use a method that defines the nonforfeiture rate as the lowest rate in a specified time period. This requirement promotes uniformity and fairness because it prohibits an insurer from picking the lowest nonforfeiture rate in a specified time period, which would disadvantage consumers.

Subsection 2523.1(a)(1)(A) also requires that a method based on changes in CMT levels must move up or down in an identical manner with changes in interest rates, subject to statutory minimums and maximums. This ensures that consumers receive a nonforfeiture rate that moves up and down with the CMT rate. This promotes uniformity in the methodology used. It also prevents insurers from unfairly manipulating the method to magnify decreases and minimize increases, which would tend to lower the required minimum nonforfeiture amounts generated by the methodology, to the detriment of consumers. For clarity, Subsection 2523.1(a)(1)(A) sets forth what is meant by “NAIC” by including the name of the organization before the acronym.

Subsection 2523.1(a)(1)(B) and its subparts set forth uniform requirements that apply if the insurer chooses a basis that uses a specified period determined by the level of change in the

CMT rate. When the subsection is first used by the insurer for a contract form, the insurer must determine the nonforfeiture interest rate using “a specified period or another approved date dependent methodology.” The insurer must then define a “symmetrical range” that will determine when the rate will be updated, with a maximum range of plus or minus 50 basis points. This establishes a symmetrical range with uniform, reasonable limits (plus or minus 50 basis points). Subsection 2523.1(a)(1)(B)(3) requires the insurer to calculate a potential nonforfeiture rate at the beginning of each period the company specifies during which the nonforfeiture rate will remain fixed, using the methodology in Subsection 2523.1(a)(1)(B)(1), without using any caps or floors. If the difference between the potential nonforfeiture rate and the current initial nonforfeiture rate is less than or equal to the symmetrical range described above, the current nonforfeiture rate shall not be updated as described in Subsection 2523.1(a)(1)(B)(4). However, if the difference is more than the range, the current nonforfeiture rate shall be updated to be equal to the potential nonforfeiture rate adjusted for rounding and any caps or floors as described in Subsection 2523.1(a)(1)(B)(5). The word “above” does not appear in the NAIC Model # 806 but was added to Subsection 2523.1(a)(1)(B)(3) for clarity, to eliminate any problem of confusion as to the location of the subsection referred to.

The purpose of Subsections 2523.1(a)(1)(B)(1) through (5) is to require the insurer to update the nonforfeiture rate when the underlying five-year CMT rates have changed significantly as reflected in the potential nonforfeiture rate calculation, but also to require the insurer to leave the existing nonforfeiture rate unchanged if the potential nonforfeiture rate calculation falls within the range. This approach is reasonably necessary to promote stability and predictability in the nonforfeiture rates used by insurers, yet it still requires insurers to adjust nonforfeiture rates when necessary to reflect significant changes in the CMT rate and thus maintain a relationship between the nonforfeiture rate and the CMT rate. It would be unreasonable, unduly burdensome, and unnecessarily expensive in terms of administrative costs to require an insurer to adjust its nonforfeiture rate for each change in the CMT rate, no matter how small. The proposed regulation addresses the problem that arises in implementing Section 10168.25 when there are no rules of general application on when and how insurers should adjust nonforfeiture rates which use as their basis a specified period determined by the level of change in the CMT rate.

Subsection 2523.1(a)(1)(B)(6) refers the reader to examples as a way of clarifying the meaning of the preceding subsections. It differs from the NAIC Model # 806 for purposes of clarity in that the word “attached” was deleted and in its place there is a more complete descriptive reference to the examples now set forth as Section 2523.6 Appendix A. This subsection is reasonably necessary to refer the reader to Appendix A where the reader can find examples of how the proposed regulations work in practice. Subsection 2523.1(a)(1)(B)(6) addresses the clarity and uniformity problems that arise in the implementation of Section 10168.25 by referring the reader to an appendix that illustrates how the regulations apply to implement, interpret, and make specific Insurance Code Section 10168.25.

By setting forth these requirements, Subsection 2523.1(a) is reasonably necessary to define and clarify what is and isn't permitted in determining a basis under Section 10168.25. Subsection 2523.1(a) prevents insurers from using nonforfeiture methodology that would be unfair to consumers. Subsection 2523.1(a) also saves time and money by clarifying exactly what methodology is required to calculate nonforfeiture amounts under Section 10168.25. Insurers

can prepare their actuarial calculations more efficiently, without wasting resources on methodology that the Commissioner might find unacceptable. Finally, by tracking the substance of NAIC Model # 806, proposed Subsection 2523.2(a)(1)(B) promotes uniformity. For these reasons the Commissioner anticipates that adoption of the proposed regulation will be beneficial.

As noted above, Subsection 2523.1(a)(2) defines “basis” in the context of equity-indexed benefits. This definition is reasonably necessary because one must define “basis” in order to implement the statute as to equity-indexed benefits, but the statute itself does not set forth a definition of “basis” in that context. Without this definition it would be unclear exactly what is meant when the proposed regulations use this term in the context of equity-indexed benefits. The definition is reasonably necessary for clarity and uniformity in the implementation of Insurance Code Section 10168.25.

The purpose of Subsection 2523.1(b) is to define “equity-indexed benefit.” The subsection clarifies what types of benefits are equity-indexed benefits and what types are not. The term “equity-indexed benefit” is used in both Insurance Code Section 10168.25 and the proposed regulations (the Insurance Code term lacks a hyphen, but this difference is non-substantive). The definition is reasonably necessary because without it it would be unclear in some instances exactly what is meant by “equity-indexed benefit.” The definition is therefore reasonably necessary to achieve greater clarity and uniformity in the implementation of Insurance Code Section 10168.25. This subsection differs from NAIC Model # 806 only in the deletion of the letter “s” at the end of the word “benefit.” Since the text uses “benefit” in the singular, the defined term should be singular as well to be consistent.

The purpose of Subsection 2523.1(c) is to define “index term.” Without this definition it would be unclear what is meant when the proposed regulations use this term. The definition is reasonably necessary for clarity and uniformity in the implementation of Insurance Code Section 10168.25.

The purpose of Subsection 2523.1(d) is to define “initial method.” Without this definition it would be unclear what is meant when the proposed regulations use this term. The definition is reasonably necessary for clarity and uniformity in the implementation of Insurance Code Section 10168.25.

The purpose of Subsection 2523.1(e) is to define “initial nonforfeiture rate.” Although Insurance Code Section 10168.25 allows insurers to determine an interest rate that applies for an initial period and may be redetermined for additional periods, the actual terms “initial nonforfeiture rate” and “redetermination nonforfeiture rate” are not defined in the statute. It would be unclear what is meant when the proposed regulations use these terms if the terms are not defined. The definition of “initial nonforfeiture rate” is reasonably necessary for clarity and uniformity in the implementation of Insurance Code Section 10168.25.

The purpose of Subsection 2523.1(f) is to define “minimum nonforfeiture amount.” The term “minimum nonforfeiture amount” is used in both Insurance Code Section 10168.25 and the proposed regulations. The definition set forth in Subsection 2523.1(f) links the term as used in the proposed regulations with its statutory definition. It is reasonably necessary for clarity and

uniformity in the implementation of Insurance Code Section 10168.25 to define this term. The definition differs from NAIC Model # 806 in that citations to California law have been inserted where the Model indicates each state should cite to its own legal authority.

The purpose of Subsection 2523.1(g) is to define “nonforfeiture rate.” Although determination of the nonforfeiture rate for a product is required in order to comply with Insurance Code Section 10168.25, the statute does not expressly define the term. Instead, it refers to the interest rate used in determining minimum nonforfeiture amounts. Without this definition it would be unclear what is meant when the proposed regulations use this term. The definition is reasonably necessary for clarity and uniformity in the implementation of Insurance Code Section 10168.25. The definition differs from NAIC Model # 806 in that citations to California law have been inserted where the Model indicates each state should cite to its own legal authority.

The purpose of Subsection 2523.1(h) is to define “redetermination method.” Although Insurance Code Section 10168.25 contains requirements that apply to a redetermination method calculation, the statute does not define the term “redetermination method.” Without this definition it would be unclear what is meant when the proposed regulations use this term. The definition is reasonably necessary for clarity and uniformity in the implementation of Insurance Code Section 10168.25.

Subsection 2523.1(i) defines “redetermination nonforfeiture rate” as the nonforfeiture rate applicable at redetermination. Although Section 10168.25 specifies that the interest rate used in determining minimum nonforfeiture amounts may be redetermined for additional periods, it does not define the term “redetermination nonforfeiture rate.” Without this definition it would be unclear what is meant when the proposed regulations use this term to implement the statute. The definition is reasonably necessary for clarity and uniformity in the implementation of Insurance Code Section 10168.25.

### **Section 2523.2. Initial Method**

The purpose of proposed Section 2523.2 is to specify that the initial method shall be filed with the Commissioner in accordance with applicable filing and approval requirements, and to clarify how often changes to the initial method may be made, to what contracts changes in the method would apply, and whether the initial method, the initial nonforfeiture rate, and the minimum nonforfeiture parameters must be disclosed in the insurance contract. These specifics are not set forth in Insurance Code Section 10168.25. All of these specifics are reasonably necessary to clarify and implement the statute in a uniform way.

Proposed Section 2523.2 differs from NAIC Model # 806 in that references to California law have been inserted where the Model refers to “jurisdictional” requirements or indicates that each state should cite to its own legal authority. It also differs in that a drafting note in NAIC Model # 806 was omitted in the proposed regulation because it was merely a suggestion rather than a rule of general application.

### **Section 2523.3. Redetermination Method**



The purpose of proposed Section 2523.3 is to set forth disclosure requirements for use of the redetermination method and to establish when changes in the redetermination method are allowed, subject to California filing and approval requirements. These requirements are not set forth in Insurance Code Section 10168.25. The proposed regulation is reasonably necessary to clarify and implement the statute in a uniform way.

Proposed Section 2523.3 differs from NAIC Model # 806 in that a reference to California filing and approval requirements has been inserted where the Model refers to “jurisdictional” filing and approval requirements.

#### **Section 2523.4. Nonforfeiture Rate and Minimum Nonforfeiture Amount**

The purpose of this section is to specify requirements applicable to the nonforfeiture rate and the minimum nonforfeiture amount for an annuity contract (or certificate), depending on whether or not the product provides an equity-indexed benefit. Although Insurance Code Section 10168.25 applies to both types of contracts, the statute sets forth general requirements. It does not address a number of more specific issues that arise in determining the nonforfeiture rate and the minimum nonforfeiture amounts – those issues are addressed in the proposed regulation. Proposed Section 2523.4 is reasonably necessary in order to clarify and implement the statute in a uniform way.

Section 2523.4(a) of this section clarifies that at any point in time a contract (or certificate) without an equity-indexed benefit will have just one nonforfeiture rate and one nonforfeiture amount applicable to the entire contract that is determined in compliance with Insurance Code Section 10168.25. This subsection is reasonably necessary in order to clarify and implement the statute, which does not address these issues.

Section 2523.4(b) clarifies that for an annuity contract (or certificate) in which equity-indexed benefits are available the annuity contract (or certificate) may have more than one nonforfeiture rate applicable to the contract (or certificate), subject to the requirements set forth in Subsections 2523.4(b)(1) through (6). Subsections 2523.4(b)(1), (2), and (3) are reasonably necessary because they expand on Insurance Code Section 10168.25 by setting forth specifics on how to calculate the nonforfeiture rate and the minimum nonforfeiture amount for contracts (or certificates) in which equity-indexed benefits are available. Existing law does not provide guidance on these points.

Subsection 2523.4(b)(4) specifies how to calculate the minimum nonforfeiture amount when the contract value is transferred in a contract which has equity-indexed benefits. The proposed subsection is reasonably necessary because existing law does not address this subject. In addition, Subsection 2523.4(b)(4) refers the reader to examples as a way of clarifying how Section 10168.25 and the proposed regulations should be implemented in particular scenarios. It differs from the NAIC Model # 806 for purposes of clarity in that the Model’s reference to Appendix B was rephrased in favor of a more complete descriptive reference to the examples now set forth as Section 2523.6 Appendix B. The reference to Appendix B is reasonably necessary to refer the reader to Appendix B where the reader can find an example of how the proposed regulations work in practice.

Subsection 2523.4(b)(5) specifies how to calculate the minimum nonforfeiture amount when there is a withdrawal from a benefit in which the amount of withdrawal exceeds the benefit's nonforfeiture amount. The proposed subsection is reasonably necessary because existing law does not provide guidance on this subject.

Subsection 2523.4(b)(6) specifies how to allocate any contract charge or premium taxes paid by the company in calculating the minimum nonforfeiture amount. The proposed subsection is reasonably necessary because existing law does not provide guidance on this subject.

### **Section 2523.5. Equity-Indexed Benefits**

Insurance Code Section 10168.25(e) allows insurers to reduce the nonforfeiture rate by up to 100 basis points during the period or term that a contract provides substantive participation in an equity-indexed benefit to reflect the value of that benefit. However, Insurance Code Section 10168.25(e) provides only general guidance on a reduction in the nonforfeiture rate to reflect the value of the equity-indexed benefit.

Insurance Code Section 10168.25(e) also allows the Commissioner to require a demonstration that the present value of the additional reduction does not exceed the market value of the benefit, and it authorizes the Commissioner to disallow or limit the reduction if the demonstration is not acceptable. However, Insurance Code section 10168.25(e) does not explain what would be considered an adequate demonstration. Instead, Insurance Code Subsection 10168.25(f) expressly provides that the Commissioner "may adopt regulations to implement the provisions of subdivision (e) and to provide for further adjustments to the calculation of minimum nonforfeiture amounts for contracts that provide substantive participation in an equity index benefit...."

The purpose of Section 2523.5 is to implement the provisions of Insurance Code Section 10168.25, and in particular those of Subsections 10168.25(e) and (f). Section 2523.5 specifies what insurers have to do to take the additional reduction in the nonforfeiture interest rate calculation for an equity-indexed benefit and demonstrate that the reduction is in compliance with Insurance Code Section 10168.25(e). The proposed section is reasonably necessary because existing law does not provide guidance on this subject. The proposed regulation clarifies and implements the statute in a uniform way.

More specifically, proposed Section 2523.5(a) provides that if a company chooses to take the additional reduction for an equity-indexed benefit as provided under Subsection 10168.25(e), the company shall prepare a demonstration showing compliance with the requirements in Subsection 10168.25(e). By requiring a demonstration to be prepared by all companies seeking the additional reduction, Subsection 2523.5(a) fairly and uniformly implements the requirements of Section 10168.25 (because the requirement applies to all companies seeking the reduction) and it provides the Commissioner with the information needed to evaluate the reductions. This subsection is reasonably necessary because existing law does not specify whether a demonstration is required. Subsection 2523.5 addresses that issue by creating a clear, uniform requirement.

Section 2523.5(b)(1) sets forth the steps insurers must use to prepare the demonstration required by Subsection 2523.5(a). The steps are specific instructions to the companies as to how they must calculate the annualized option cost for the equity-indexed benefit. By setting forth the steps the companies must take, the proposed regulation creates certainty where there is now uncertainty. It can save companies time and effort because it tells them what they need to do to prepare the demonstration. Companies need not waste time preparing documentation that is unnecessary or unwanted by the commissioner.

Existing law does not say what constitutes “substantive participation” in an equity-indexed benefit under Insurance Code Section 10168.25(e). “Substantive participation” can be interpreted in more than one way. Therefore it is reasonably necessary to define what constitutes “substantive participation” in an equity-indexed benefit in order to determine whether a product qualifies for the reduction allowed by Subsection 10168.25(e). Subsection 2523.5(b)(2) addresses this issue by stating how much the equity-indexed benefit must cost in order for it to meet the “substantive participation” requirement in the statute.

Subsection 2523.5(b)(3) requires that companies prepare and file an actuarial certification as set forth in Section 2523.6 Appendix C with their demonstration, certifying that the reduction complies with the minimum requirements of California’s annuity nonforfeiture statutes and the proposed regulations. Subsection 2523.5(b)(4) requires that companies prepare and file an actuarial certification as set forth in Section 2523.6 Appendix D with their annual statements, with regard to ongoing compliance with the proposed regulations. Existing law does not contain actuarial certification requirements that pertain to the implementation of Insurance Code Section 10168.25 in particular.

The actuarial certification requirements are reasonably necessary because without them anyone could certify that a filing complies with applicable requirements, whether they are qualified to do so or not. The purpose of the new subsections requiring certification by a member of the American Academy of Actuaries is to require that the filings be certified by someone who has had extensive actuarial education and who is subject to professional standards of practice. These requirements also help to ensure that the calculations and data supplied to the regulator are thorough, accurate, and in compliance with applicable requirements. In addition, the actuarial certification requirements protect consumers by increasing the likelihood that the insurer is complying with statutory requirements, which exist in part to protect consumers. Addition of the actuarial certification requirements is reasonably necessary to carry out this purpose and to foster greater uniformity in regulatory standards.

A drafting note from NAIC Model # 806 has been incorporated into the proposed regulations as Subsection 2523.5(b)(5), with substitution of the word “shall” for “should” to require uniform compliance. By requiring companies to maintain demonstrations and work papers for submission to the Commissioner if requested, this subsection helps to ensure that companies have the documentation necessary for the Commissioner to evaluate the adequacy of a demonstration. Existing law does not have a comparable requirement. This subsection is reasonably necessary to ensure that companies maintain the documents that the Commissioner would need to review in order to decide upon the adequacy of a demonstration.

Existing law gives the Commissioner the authority to disallow or limit the additional reduction permitted by Insurance Code Section 10168.25(e), but it does not specify exactly how this might occur. Subsection 2523.5(c) makes the general language of the statute specific by stating that if the Commissioner determines that the additional reduction of up to 100 basis points for equity-indexed benefits has been inappropriately taken, the Commissioner may require the recalculation of all values for all affected policyholders without all or part of the additional reduction. This provision is reasonably necessary to make the general requirement of Insurance Code Section 10168.25(e) specific. Subsection 2523.5(c) creates a standard by which both the companies' and the Commissioner's actions will be guided, which promotes fairness, uniformity, and predictability in the review process.

To the extent the language of Section 2523.5 diverges from that of NAIC Model # 806 it does so for purposes of clarification and to conform the language of the Model to California law and to the format and terminology used in the California Code of Regulations. Specifically, citations to California Insurance Code Subsection 10168.25(e), California Insurance Code Sections 10168 to 10168.10, and the proposed regulations have been inserted in place of references to Section 4C of the Standard Nonforfeiture Law for Individual Deferred Annuities, NAIC Model # 805, and "insert reference" provisions. In addition, the words "index term" are not capitalized, for consistency and clarity, because other defined terms in the proposed regulations are not capitalized. For greater clarity, commas have been inserted in Subsections 2523.5(b)(3) and (4) after the word "Actuaries," and the words "with this Article" have been inserted in Subsection 2523.5(b)(4) after the word "compliance." The word "minimum" has been inserted before the word "requirements" in Subsection 2523.5(b)(3) because it makes the reference consistent with the language of Appendix C. The language in Subsections 2523.5(b)(3) and (5) regarding submission of the Appendix C certification, demonstrations, and work papers has been rewritten to provide that the company shall maintain the documents, "which shall be submitted to the commissioner if requested." (The Model simply says the Appendix C certification shall be submitted "according to the requirements of the jurisdiction" and the demonstrations and work papers "should" be "submitted if requested.") The modification of the Model's language makes treatment of the documents more uniform and clarifies that the Appendix C certification, the demonstrations, and the work papers must be maintained, but that they need not be filed with the Commissioner unless the Commissioner requests them.

A drafting note from NAIC Model # 806 that refers to filing requirements has not been incorporated into the proposed regulation because it is not necessary to do so. A second drafting note from the Model has been incorporated into the proposed regulation as Subsection 2523.5(b)(5), as explained above.

### **Section 2523.6. Appendices A to D**

Proposed Section 2523.6 is comprised of four appendices.

The purpose of the first two appendices is to implement, interpret, and make specific Insurance Code Section 10168.25 by illustrating how the proposed regulations apply in particular situations. Appendix A illustrates indexing methods dependent upon changes in CMT levels by

way of four examples that apply the proposed regulations to various scenarios. Appendix B shows a demonstration of how the minimum nonforfeiture amount is to be transferred in an equity-indexed annuity under proposed regulation Section 2523.4. Appendix A and Appendix B are reasonably necessary to clarify how the proposed regulations apply to common scenarios.

The purpose of Appendix C and Appendix D is to implement the provisions of Insurance Code Section 10168.25 by setting forth the texts of the actuarial certifications required by proposed regulation Subsections 2523.5(b)(3) and 2523.5(b)(4), respectively. Appendix C and Appendix D are reasonably necessary to foster compliance with the statute and to clarify what companies are required to prepare and file in order to comply with Subsections 2523.5(b)(3) and 2523.5(b)(4) of the proposed regulations. Appendix C and Appendix D make the proposed regulations clearer. Without these Appendices companies would not know what language the Commissioner expects to see in the actuarial certifications. They also make it easier for companies to comply with the actuarial certification requirement because they are fill-in-the-blank-type forms that have just four blanks (Appendix C) and five blanks (Appendix D). The information required to complete the blanks, such as the actuary's name, professional designation, and the name of the insurer submitting the form is readily available. The standardized nature of Appendices C and D fosters greater uniformity in regulatory standards.

To the extent the language of Section 2523.6 diverges from that of NAIC Model # 806 it does so for purposes of clarification, to conform the language of the Model to California law and to the format and terminology used in the California Code of Regulations, and to correct punctuation. These changes are reasonably necessary to achieve greater clarity. Without these changes the Appendices would be less clear to the reader. Specifically, citations to the California Insurance Code and the proposed regulations have been inserted into Appendices B, C, and D where appropriate to make legal references California-specific. To ensure clarity, the word "nonforfeiture" has been inserted in Appendix A before the abbreviation "NF" and parentheses and quotation marks have been placed around the abbreviation. The words "basis points" have been inserted in Appendix A before the abbreviation "bps" and parentheses and quotation marks have been placed around the abbreviation, also for clarity. The abbreviation "EIA" in parentheses has been placed in Appendix B after the first mention of "equity-indexed annuity" to clarify that subsequent references to "EIA" are references to "equity-indexed annuity." The word "sources" and a hyphen have been added in front of the website addresses listed in Appendix A, also for clarity (the notation number (1) at the bottom of Appendix A refers to the website addresses as "sources," so the addition of the word "sources" clarifies both the reference in (1) and the identification of the sources themselves. The word "the" was inserted into item (2) at the bottom of Appendix A before the word "potential," to clarify that what is being referred to is "the potential nonforfeiture rate," and the comma after "rate" has been moved to within the quotation marks to correct the punctuation placement. In addition, the quotation marks around the word "accordingly" at the bottom of Appendix B have been removed because the word "accordingly" is not a term of art or a defined term in the regulations. Therefore the quotation marks are unnecessary and serve only to create a lack of clarity.

Appendix C has been revised to state that it is for use with equity-indexed annuity contract forms "pursuant to California Code of Regulations, Title 10, Section 2523.6(b)(3)," in place of the Model language which states that the certification is for use "at time of filing." The "time of

filing” language is not necessarily correct because in California the Appendix C certification need not be filed with the Commissioner unless the Commissioner so requests. Therefore, the revised language is reasonably necessary to conform the language of Appendix C to California law.

The Commissioner anticipates that the changes described above will make the Appendices clearer and less confusing, which will benefit the reader.

### **IDENTIFICATION OF STUDIES**

The Commissioner has relied upon the Economic Impact Assessment prepared pursuant to Government Code Section 11346.3(b) in proposing the proposed regulations. A copy of the Economic Impact Assessment is included in the rulemaking record. There are no other technical, theoretical, and empirical studies, or similar documents relied upon in proposing the adoption of the proposed regulations. The Commissioner has relied upon the Standard Nonforfeiture Law for Individual Deferred Annuities NAIC Model # 805, NAIC Model # 806, and California’s Standard Nonforfeiture Law for Individual Deferred Annuities, Insurance Code Sections 10168 to 10168.10 in proposing adoption of the regulations. Copies of the Standard Nonforfeiture Law for Individual Deferred Annuities NAIC Model # 805, NAIC Model # 806, and Insurance Code Sections 10168 to 10168.10 are included in the rulemaking file.

### **SPECIFIC TECHNOLOGIES OR EQUIPMENT**

Adoption of these regulations would not mandate the use of specific technologies or equipment.

### **REASONABLE ALTERNATIVES TO THE PROPOSED REGULATIONS**

The Commissioner must determine that no reasonable alternative considered by the agency or that has otherwise been identified and brought to the attention of the Department of Insurance would be more effective in carrying out the purpose for which the regulations are proposed, would be as effective and less burdensome to affected private persons than the proposed regulations, or would be more cost-effective to affected private persons and equally effective in implementing the statutory policy or other provision of law.

The Commissioner has considered and rejected the following reasonable alternatives to the proposed regulations:

Alternative #1.

The Commissioner has considered not adopting the provisions of NAIC Model # 806 or any portion of the Model. Some may propose this alternative as less burdensome and more cost-effective to insurers than the proposed regulations, and equally effective or more effective in carrying out the purpose of the proposed regulations because the provisions of Insurance Code Section 10168.25 are clear and there is currently no impediment to full compliance with the statute.

The Commissioner disagrees. While it may be somewhat less burdensome or more cost-effective in some respects to not adopt the proposed regulations, it is more burdensome overall not to do so. Insurers presently lack guidance from California law on implementing many of the statutory provisions with which they must comply. This can produce inefficiencies when insurers prepare and submit calculations that the Commissioner finds do not meet statutory requirements. Also, it fails to address the uncertainties that have arisen as insurers apply the general statutory standards to very specific issues. Moreover, it ignores the Legislature's intent to implement Insurance Code Section 10168.25 by way of regulations, as evidenced in two statutes, Insurance Code Subsection 10168.25(f) and Insurance Code Section 10168.92, both of which give the Commissioner express rulemaking authority. Finally, it would be a rejection of an opportunity to adopt standards developed by a national organization that could promote uniformity with the laws of other states. For these reasons the Commissioner has determined that this alternative would not be more effective in carrying out the purpose for which the regulations are proposed, would not be as effective and less burdensome to affected private persons than the proposed regulations, and would not be more cost-effective to affected private persons and equally effective in implementing Insurance Code Section 10168.25 as the proposed regulations.

#### Alternative #2.

The Commissioner has also considered adopting a modified version of NAIC Model # 806 that would set forth all provisions of the proposed regulations except for the actuarial certification requirements. This alternative might be proposed as a way to lessen the burden on insurers or be more cost-effective for them while being equally effective or more effective in achieving the purpose of the proposed regulations, in a manner that ensures full compliance with Insurance Code Section 10168.25.

The Commissioner disagrees with this proposal as well. While removing the actuarial certification requirement might lessen the burden on insurers somewhat, it would not make the rest of the proposed regulations equally effective or more effective in achieving the purpose of the proposed regulations in a manner that ensures full compliance with Insurance Code Section 10168.25.

As explained earlier in this Initial Statement of Reasons, without the actuarial certification requirements anyone could certify that a filing complies with applicable requirements, whether they are qualified to do so or not. The purpose of the new subsections requiring certification by a member of the American Academy of Actuaries is to require that the filings be certified by someone who has had extensive actuarial education and who is subject to professional standards of practice. These requirements also help to ensure that the calculations and data supplied to the regulator are thorough, accurate, and in compliance with applicable requirements. In addition, the actuarial certification requirements protect consumers by increasing the likelihood that the insurer is complying with statutory requirements, which exist in part to protect consumers. Moreover, deletion of the requirements in California would create a lack of uniformity with the law of any other state that adopts NAIC Model # 806. Omission of the actuarial

certification requirements would not be equally effective or more effective than the proposed regulations in achieving the purpose of the regulations in a manner that ensures full compliance with Insurance Code Section 10168.25. For these reasons the Commissioner has determined that this alternative would not be more effective in carrying out the purpose for which the regulations are proposed, would not be as effective and less burdensome to affected private persons than the proposed regulations, and would not be more cost-effective to affected private persons and equally effective in implementing Insurance Code Section 10168.25 as the proposed regulations.

In addition to the two alternatives above, the Commissioner considered the imposition of performance standards as a way of making the provisions of Insurance Code Section 10168.25 more specific. However, the Commissioner rejected performance standards because they are ill-suited, more burdensome, and not equally effective or more effective than the proposed regulations in implementing Section 10168.25 and promoting full compliance with that statute.

### **ADVERSE IMPACT ON SMALL BUSINESS**

The Commissioner has identified no reasonable alternatives to the presently proposed regulations, nor have any such alternatives otherwise been identified and brought to the attention of the Department, that would lessen any adverse impact on small businesses.

The Commissioner has determined that the proposed regulations will affect insurance companies. Insurance companies are not small businesses pursuant to California Government Code section 11342.610(b)(2).

### **PRENOTICE DISCUSSIONS**

The Commissioner has not conducted a prenotice public discussion of the proposed regulations pursuant to Government Code Section 11346.45 because he has concluded that the proposed regulations do not “involve complex proposals or a large number of proposals which cannot be easily reviewed during the comment period.” Government Code Section 11346.45(a).

The proposed regulations are for the most part the same as NAIC Model # 806. The NAIC finalized Model # 806 several years ago. NAIC Model # 806 is the product of over two years of NAIC-sponsored quarterly committee meetings and conference calls. Interested parties had the opportunity to participate in the meetings and to comment on the Model. The insurance industry generally follows NAIC activities, and in general interested parties in California are already following NAIC Model # 806.