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BILL ANALYSIS

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House Bill 5050 (Substitute H-1 as reported without amendment)
Sponsor: Representative David Robertson
House Committee: Insurance
Senate Committee: Banking and Financial Institutions

Date Completed: 10-22-03

RATIONALE

In response to the economic downturn and fluctuations in the stock market, Public Act 635 of 2002 amended the Insurance Code to reduce, for three years, the minimum interest rate that is used to determine the cash surrender value of individual fixed annuities. A fixed annuity contract is a type of investment, commonly issued by an insurance company, that repays the capital invested (premiums paid) plus a fixed rate of return over a set period of time. If the contract is surrendered before the benefit is paid, the cash value must be based on a "minimum nonforfeiture amount", which refers to the value of accumulated payments, minus certain charges, such as prior withdrawals and loans, subject to the "minimum nonforfeiture rate". That rate is the lowest interest rate that an insurer may apply to accumulated payments in order to determine the minimum nonforfeiture amount.

Under Public Act 635, the minimum nonforfeiture rate is 1.5% until 2005, when it is scheduled to revert to 3%. This legislation was designed to provide a temporary solution while the National Association of Insurance Commissioners (NAIC) developed a recommendation for a permanent rate index that would include an adjustable minimum rate. In March 2003, the NAIC produced model language for such a rate.

CONTENT

The bill would amend the Standard Nonforfeiture Law for Individual Deferred Annuities, within the Insurance Code, to revise the minimum nonforfeiture rate of an annuity contract, beginning on January 1, 2005; and allow insurers to proceed under either the existing or the new rate until that date. The proposed minimum rate could not be less than 1% or more than 3%, and would be calculated according to a five-year Treasury rate. The bill also would require approval of the Commissioner of the Office of Financial and Insurance Services for an insurer to defer the payment of a cash surrender benefit.

Under the Law, the minimum value of a paid-up annuity, cash surrender, or death benefits available under an annuity contract must be based on a minimum nonforfeiture amount. For an annuity contract providing for flexible considerations (amounts paid by the investor), the minimum nonforfeiture amount, before or at the time annuity payments begin, must be "equal to an accumulation up to that time at a rate of interest of 1.5% per annum of net considerations...paid before that time", increased by any additional amounts credited by the company to the contract, and decreased by 1) prior withdrawals from or partial surrenders of the contract accumulated at an annual interest of 1.5%, and 2) the amount of any indebtedness to the company on the contract. On January 1, 2005, the annual interest rate will return to 3%.

Under the bill, beginning on January 1, 2005, the rate of interest used in determining the minimum nonforfeiture amount would have to be "an annual rate of interest determined as the lesser of 3% per annum and the following...:

"(a) The 5-year constant maturity treasury rate reported by the federal reserve as of a date, or average over a period, rounded to the nearest [20th] of 1%, specified in the contract no longer than

15 months before the contract issue date or redetermination date under subdivision (d).

(b) Reduced by 125 basis points.

(c) Where the resulting interest rate is not less than 1%.

(d) The interest rate shall apply for an initial period and may be redetermined for additional periods. The redetermination date, basis, and period, if any, shall be stated in the contract..."

Under this formula, the following amounts, accumulated at rates of interest described above, would have to be deducted:

-- Prior withdrawals from or partial surrenders of the contract.
-- An annual contract charge of $50.
-- Any premium tax paid by the company for the contract.

Until January 1, 2005, insurers could choose to use either the existing or the proposed calculation of the minimum nonforfeiture amount. Beginning on that date, insurers would have to proceed under the new formula.

Currently, for contracts providing for fixed scheduled considerations or a single consideration, the minimum nonforfeiture amounts are defined as for contracts with flexible considerations, subject to certain assumptions and adjustments. The bill would delete these provisions. (The minimum nonforfeiture amount under the bill would not apply solely to contracts with flexible considerations.)

Under the bill, the "net consideration" for a given contract year used to define the minimum nonforfeiture amount would have to equal 87% of the gross considerations credited to the contract during that year. (Currently, the net consideration may not be less than zero and must equal the corresponding gross considerations credited to the contract during that contract year, less an annual contract charge of $30 and a collection charge of $1.25 per consideration credited to the contract during that year. As a rule, the percentages of gross consideration must be 67% for the first contract year and 87.5% for each subsequent year.)

Under the Law, if a contract provides for a lump sum settlement at maturity or at any other time, the company must pay a cash surrender benefit in place of any paid-up annuity benefit upon surrender of the contract before or when annuity payments begin. The company must reserve the right to defer the payment of the cash surrender benefit for six months the contract is surrendered. Under the bill, the company would be permitted to reserve the right to defer payment for six months if it made a written request to the Commissioner, showing the necessity and equitability to all policyholders of the deferral, and the Commissioner gave written approval.

Currently, cash surrender benefits available before maturity may not be less than the present value as of the date of surrender of that portion of the maturity value of the paid-up annuity benefit arising from consideration paid before the time of surrender. Under the bill, this amount would be reduced by the amount appropriate to reflect any prior withdrawals from or partial surrenders of the contract. Currently, the present value must be calculated on the basis of an interest rate not more than 1% higher than the interest rate specified in the contract for accumulating the net consideration to determine the maturity value. Under the bill, this amount would be decreased by the amount of any indebtedness to the company on the contract, including interest due and accrued, and increased by any existing additional amounts credited by the company to the contract.

MCL 500.4072

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

The minimum nonforfeiture rate is designed to represent the level below which interest rates are not expected to fall. Before Public Act 635 of 2002 was enacted, the minimum rate had been set at 3% over 20 years earlier, when investments provided considerably higher returns than they do today. By allowing life and annuity insurance companies to lower their minimum interest rate for individual fixed annuities, Public Act 635 helped to alleviate concerns that the minimum interest rate might exceed the actual market rate. If insurers were forced to pay interest above actual

market rates for a long period of time, it was feared that some insurers would become insolvent or withdraw certain annuity products from their portfolio.

While Public Act 635 provided for a temporary solution, House Bill 5050 (H-1) would establish a permanent rate index with a moveable floor. This would eliminate the need for future statutory amendments when market conditions change. The minimum rate could not go below 1% but, if the Treasury rate increased, it could reach 3%--the minimum rate in effect before Public Act 635 was enacted and the rate that will apply beginning in 2005 if the law is not amended. Since the actual rate used in any particular contract varies by company and product design, it is likely that annuity insurers will increase their guaranteed rates above the minimum when the market rebounds, in order to stay competitive.

Supporting Argument

Rate guarantees that exceed market rates can reduce consumer choice in the annuity marketplace of certain popular contract designs and options. In 2002, it was reported that many companies had stopped offering short-term annuities, such as one- to three-year contracts, because the statutory minimum rate was higher than the market rate. Like Public Act 635, this proposal would support the availability of these choices.

Supporting Argument

Adopting the NAIC model language would help to keep Michigan in line with other states in the individual deferred annuity market, and would promote the standardization of annuity contracts throughout the states. According to the Office of Financial and Insurance Services, the NAIC sought input from consumers, the industry, and other interested parties in developing the model act, and used actuaries to analyze the implications of the new index rating methodology. The NAIC and other states believe that the new model protects both consumers and the industry from being disadvantaged in an ever-changing market.

Legislative Analyst: Suzanne Lowe

FISCAL IMPACT

The bill would have no fiscal impact on State or local government.

Fiscal Analyst: Maria Tyszkiewicz

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.