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Life and Annuity Product Innovation: A Former Regulator's Perspective

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I have come to realize that there are a number of different perspectives on product innovation. Most of my 30 years' experience with product innovation derives from my career as a product regulator with the New York State Insurance Department (now the Department of Financial Services). As such, my perspective is New York-centric and focused on product regulation and not on product development stages that occur prior to or after product approval. Given this background, I would like to discuss (1) the contours of product innovation from a regulatory perspective, (2) some of the forces driving innovation, and (3) the regulatory hurdles that insurers and regulators face in a statutory and regulatory environment that cannot keep pace with innovation.

Scope of Product Innovation

As a threshold matter, it should be noted that the term *product innovation* for insurance regulators refers to the development of new products, new features or benefits, and new restrictions or limitations on benefits. Examples of recent product developments include guaranteed paid-up deferred annuities (longevity annuity) and contingent annuities. Examples of features and benefits include guaranteed living benefits in variable annuities, no-lapse guarantees in universal life insurance, and accelerated death benefits in life insurance. Examples of restrictions and limitations include market timing and fixed-account availability restrictions in variable annuities, underwriting restrictions in application forms, and limitations on assignment and contestability designed to prevent stranger-owned life insurance and annuities and the extension of preferred and reentry rating to group association programs.

Product Innovation is Ongoing

The term *product innovation* is a relative term, in that, the innovation may continue to evolve for years before it becomes standardized and/or statutory and regulatory constraints are in place. For example, both equity indexed products and guaranteed living benefits in variable products have been evolving for more than 15 years. Indeed, more innovation should be expected for indexed products now that the uncertainty regarding the status of equity indexed annuities under federal securities laws has been resolved. In addition, New York's recent guidance on excess withdrawal provisions on guaranteed minimum withdrawal benefits (GMWBs) in Circular Letter No. 5 (2011) may be the start of additional regulatory controls.

Product innovation is also relative in that differences in product development occur at different times for each insurer and for each regulatory jurisdiction. A product or feature may be considered innovative for an insurer (or jurisdiction) even if the innovation has been offered by other insurers (or in other states) for years. Some regulators may view a product as innovative until explicitly authorized by statute or regulation. The Interstate Insurance Product Regulation Commission (IIPRC) may hasten standardization because it can address product innovation in a more timely and comprehensive manner.

New York Peculiarities

New York provides a good example of a state in which innovation occurs at different rates and of the challenges insurers face in making products available throughout the country. Indeterminate premium and universal life products developed slowly in New York because products with discretionary elements (i.e., non-guaranteed elements) such as the crediting of excess interest did not fit squarely within the statutory scheme requiring the annual distribution of dividends enacted in 1906 to address abuses associated with tontine policies.

In fact, the ability to credit excess interest (which was essential for the industry to be competitive in the high interest rate environment in the 1970s) did not occur in New York until statutory changes were made in 1979 for annuities and 1982 for life insurance to make it clear that the crediting of excess interest would not make contracts participating. Similarly, concerns regarding the status of certain products in New York, such as synthetic GICs and contingent annuities, have slowed and/or halted the development of such products.

In New York, product innovation is challenging because of deviations from the NAIC model nonforfeiture law for annuities. It can be argued that the advantages of higher minimum values for cash surrender, annuity income, and death benefits required by New York's nonforfeiture law is offset by the elimination of options available outside New York that provide greater upside potential for consumers. In the case of equity-indexed products, the application of the annual excess interest crediting requirements in New York has severely limited product design and consumer choice.

Causes of Innovation

Understanding the causes of innovation is especially important for insurance regulators. A regulator who understands why an innovation is necessary or the forces driving such innovation may be more responsive to the needs of insurers and more inclined to exercise discretion in favor of approval. As such, when a new product or feature is being developed, a meeting with regulators to discuss the innovation and the reasons for such change would be helpful.

In my experience, most innovations are responses to consumer needs, current market conditions and/or regulatory requirements. The explosive period of innovation in the annuity field for the past 15 years reflects the industry's attempt to address the aging of the baby boom generation. The development of deferred income annuities and GMWBs addresses the need to protect against outliving one's assets. The addition of innovative immediate annuities and commutation provisions addresses consumer liquidity concerns. In addition, the industry's willingness to expand the use of medical underwriting for substandard/enhanced annuities outside the structured settlement context is an important step in improving the rate of annuitization.

Role of Economic Conditions

Economic conditions play a large role in product development. As noted, high interest rates in the late 1970s created the conditions for products with non-guaranteed elements in which discretionary, short-term guarantees replaced the more conservative long-term guarantees. On the life insurance side, such conditions resulted in the development of universal life insurance as well as the enactment of IRC § 7702 to remove uncertainties created by such product design. On the annuity side, such conditions transformed the fixed deferred annuity market from scheduled premium products that guaranteed fixed income to flexible premium accumulation products that provide a nest egg at retirement. This transformation to investment oriented accumulation annuities created uncertainty as to exempt status under federal securities laws which was resolved in 1986 with the SEC's adoption of Rule 151 [17 CFR Part 230.151].

The current low-interest-rate environment has also been transformative. Secondary guarantees (no-lapse guarantees) in universal life insurance are common now as consumers seek additional guarantees and regulators reconsider reserve standards for such products (Actuarial Guideline 38). In addition, deferred income annuities have been reintroduced, and consumers are becoming more aware of the need for an income component in retirement planning in addition to, or in lieu of, an accumulation component. For me, the transformation of the consumer mindset, especially with respect to longevity annuity, is one of the most interesting aspects of product innovation.

Other Conditions

Other conditions in the market also drive innovation. For example, the AIDS crisis in the 1980s led to viatical settlements, which in turn led to the development of accelerated death benefits in life insurance products. The evolution of the viatical settlements to life settlements has given rise to changes in underwriting of life insurance products and to a reconsideration of contestability provisions. In addition, the use of life insurance to fund employee benefits has spurred the growth of corporate-owned life insurance as well as state and federal safeguards, including notice and consent requirements to prevent abuses associated with janitor insurance.

Also, statutory changes in other areas often impact innovation. For example, changes in variable product expense charges from the Investment Company Act Amendments of 1996 led to the development of guaranteed living benefits in variable annuity contracts. The proposed regulations giving relief from the minimum distribution requirements for longevity annuities (that cost no more than 25 percent of the account balance or $100,000 (if less) and provide for income payments by age 85) should open the 401(k) and IRA markets for longevity annuities.

Actuarial, Accounting, and Technology Innovations

The impact of actuarial, accounting, and technology advances on product innovation cannot be overstated. Universal life insurance would not be possible without the advances in computer technology. Many of the products available today only became conceivable because of accounting and actuarial advances, such as the investment-year method of allocating investment income, segmentation of the general account assets, separate account segregation of assets, and asset/liability matching.

The investment-year method led to the concept of market value as the fair value for transfer in certain group annuity contracts. Eventually, MVAs were extended to the retail market through modified guaranteed annuities. nsulation of separate account assets led to the development of guaranteed separate account products for pension clients. The segregation of assets in such separate accounts forced asset/liability matching for guaranteed products. Asset/liability matching led innovators to conceive of guarantees based upon investment strategies and not just fixed interest rates. In addition, the authorization for market value separate accounts funding guaranteed benefits (initially intended for modified guaranteed annuities and other fixed-rate guarantee products) led to the development of separate account contracts providing guaranteed minimum benefits, including all of the guaranteed living benefits sold today. It is not clear where such actuarial, accounting, and technology advances will lead.

Regulatory Hurdles

Insurers and regulators must be mindful of the facts that (1) statutory and regulatory requirements rarely keep pace with product innovation, (2) existing law places restrictions on product design and limits regulator discretion to approve new and innovative products, and (3) statutory and regulatory changes may be necessary when regulatory discretion is limited.

In general, insurance products must conform to applicable requirements of each state's insurance law and not be inconsistent with other federal and state laws. Applicable requirements include standard, permissible, and prohibited provisions. In some cases, regulators may have discretion to approve provisions that are more favorable or at least not less favorable than such required provisions. In such cases, insurers can make a regulator's job easier by providing the reasons why the proposed innovation is more favorable or at least not less favorable.

New York was able to approve longevity annuities because it was convinced that the methodology used in determining income benefits was at least as favorable as the statutory betterment of rates requirement and because it determined that the requirement that all minimum values be based upon the actual accumulation amount was not intended to prohibit deferred annuities that fail to provide an account value, cash surrender benefit or death benefit prior to annuitization.

Discretionary Authority

Regulators also have broad discretion to disapprove other provisions that are considered misleading or unfair. In New York, the superintendent has discretion to disapprove provisions that are determined to be misleading, unjust, unfair, inequitable, or prejudicial to the interests of policyholders.

It should be noted that most "desk drawer rules" used in New York derive from this discretionary authority and were devised as a means to approve products or provisions that were not explicitly addressed in a statute or regulation. As such, desk drawer rules initially were designed to foster innovation. Of course, over time some desk drawer rules have been applied too rigidly. When confronted with a rigid or over-zealous application of a desk drawer rule, insurers should show why the proposal is not misleading, unfair, unjust, inequitable or prejudicial and that the innovation is consistent with legislative intent and/or supports an important public policy, such as fostering lifetime income.

The superintendent in New York also has discretion to approve products that are substantially similar to other kinds of insurance and to engage in any business that is incidental or ancillary to insurance business conducted by the insurer. The department exercised this discretion to approve funding agreements before explicit statutory authorization and synthetic GICs after such products were determined to be an impermissible type of financial guaranty insurance. More recently, the department exercised discretion to approve New York Life's Access Plus program, an extracontractual loan secured by a collateral assignment of the death benefit, as an alternative to life settlement under the authority to approve ancillary business.

Prohibited If Not Permitted or Permitted If Not Prohibited

It should be understood that regulators have two options in exercising discretion regarding a product innovation that is not explicitly addressed in the law. Regulators can determine that a provision is (a) prohibited if it is not explicitly permitted or (b) permitted if it is not explicitly prohibited. The safest approach for a regulator is to prohibit or disapprove an innovation that is not explicitly permitted. Of course, this approach serves to stifle innovation and keep worthwhile products off the market until statutory or regulatory changes are made. To avoid this result, insurers (and perhaps the industry as a whole) must make the effort to persuade regulators that the product innovation is in the best interest of consumers, the marketplace, or the industry and that the advantages far outweigh any potential disadvantages.

Some of the most satisfying accomplishments during my career with the department involved the creative use of discretion to approve consumer-oriented products that did not fit squarely within existing statute or regulation. For example, the approval of equity index universal life insurance required a new interpretation that the prospective determination required for excess interest was satisfied because the index crediting formula was determined at issue (or the start of crediting period) and the insurer had no discretion to alter the amount to be credited. Also, as noted above, the approval of longevity annuities required an interpretation that the nonforfeiture law did not mandate that all deferred annuities be accumulation annuities, despite explicit language that the actual accumulation amount be the basis for all minimum values.

Statutory Changes Required

There are times when statutory or regulatory changes are needed prior to product approval. As noted, the New York Department believed that legislation was necessary for the approval of excess-interest products to prevent such products from being participating contracts. In addition, statutory authorization was required for MVA products for annuities and life insurance because the nonforfeiture laws did not provide for MVAs. At the time, it was recognized that the permissible surrender charges did not adequately protect insurers against the type of disintermediation that resulted in the insolvencies of Baldwin United and Charter Securities in the early 1980s. More recently, unless reversed, the department's opinion that contingent annuities are an impermissible type of financial guaranty insurance requires a statutory fix to permit such products in New York.

Process Recommendations

I recommend that when insurers design a new or innovative product, benefit, or provision, they contact regulators as early as possible to explain the product innovation and seek input to determine whether there are any insurmountable hurdles for approval and/or any tweaks that may be needed. This early contact could save much time, effort, and expenditure. For example, the first guaranteed paid-up deferred annuity submission allowed the contract holder to take a partial lump sum at annuitization. However, under New York law, the right to a partial lump sum at annuitization triggered the requirement that cash surrender benefit be provided at all times. The product design was tweaked so that withdrawals/commutations could be made only after income payments commenced.

It is important that insurers fully explain new and innovative features in the submission process. Although regulators can withdraw the approval of products, after notice and hearing, if the product mistakenly slips through the approval process, an insurer's relationship with the regulator may be damaged if adequate explanations are not provided. It has been reported that contingent annuities were approved in some states without full explanation. However, in New York each insurer met with the department (in some cases several times) and provided thorough analysis and explanation of the product.

Of course, the approval of an innovative product, benefit or provision raises several questions. Should the insurer be given lead time to market the new and innovative product? If so, how much time? Should the department advise other insurers of the approval? If so, how should such notice be provided? Should product outlines be updated prior to approval of an innovation?

I am not sure if one answer applies to all cases. When universal life was authorized by statute in 1982, the department delayed the submission of universal life insurance products until the issuance of Circular Letter 4 (1983) in part to create a level playing field. However, when guaranteed market value separate account contracts were authorized by statute in New York in 1985, the department permitted insurers to issue guaranteed market value separate account contracts to their pension clients prior to the adoption of Regulation 128, but subjected the approvals to the condition that the contracts and separate accounts comply with the requirements of Regulation 128, which was promulgated in1990.

It appears that the development of a uniform standard may be necessary for insurers submitting innovative products through the IIPRC. However, this process may actually hasten the introduction of new products because the IIPRC has been effective in developing standards and bringing regulators and the industry together to discuss new product innovations.

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