

STATE OF ARIZONA
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DEPT. OF INSURANCE

**REPORT OF TARGETED EXAMINATION
OF
AIG ANNUITY INSURANCE COMPANY**

NAIC# 70432

AS OF

MARCH 31, 2005

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CHRISTINA URIAS
Director of Insurance

Honorable Christina Urias
Director of Insurance
State of Arizona
2910 North 44th Street, Suite 210
Phoenix, Arizona 85108-7269

Dear Director Urias:

Pursuant to your instructions and in conformity with the provisions of the Insurance Laws and Rules of the State of Arizona, a targeted examination has been made of the market affairs of:

AIG ANNUITY INSURANCE COMPANY

NAIC # 70432

The above examination was conducted by James R. Dargavel, FLMI, CIE, Examiner-in-Charge, Jerry Paugh, AIE, Senior Market Examiner and Helene I. Tomme, CPCU, CIE, Market Examinations Supervisor.

The examination covered the period of October 1, 2004 through March 31, 2005.

As a result of that examination, the following Report of Examination is respectfully submitted.

Sincerely yours,


A handwritten signature in cursive script that reads "Paul J. Hogan".

Paul J. Hogan, JD, FLMI, ALHC, CIE
Market Oversight Administrator
Market Oversight Division

AFFIDAVIT

STATE OF ARIZONA)
) ss.
County of Maricopa)

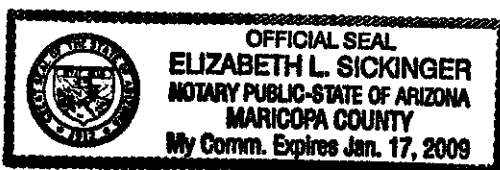
I, James R. Dargavel, FLMI, CIE, being first duly sworn state that I am a duly appointed Market Examinations Examiner-in-Charge for the Arizona Department of Insurance. That under my direction and with my participation and the participation of Jerry Paugh, AIE, Senior Market Examiner and Helene I. Tomme, CPCU, CIE, Market Examinations Supervisor, the Examination of AIG Annuity Insurance Company, hereinafter referred to as the "Company." was performed at the offices of the Arizona Department of Insurance. A teleconference meeting with appropriate Company officials was held to discuss this Report, but a copy was not provided to management, as the Examination was not finalized. The information contained in this Report, consisting of the following pages, is true and correct to the best of my knowledge and belief and that any conclusions and recommendations contained in and made a part of this Report are such as may be reasonably warranted from the facts disclosed in the Examination Report.


James R. Dargavel, FLMI, CIE
Market Examinations Examiner-in-Charge

Subscribed and sworn to before me this 14th day of September, 2006.


Notary Public

My Commission Expires Jan 17, 2009



FORWARD

This targeted market examination of AIG Annuity Insurance Company (“Company” or “AIG”), was prepared by employees of the Arizona Department of Insurance (“Department”) as well as independent examiners contracting with the Department. A targeted market examination is conducted for the purpose of auditing certain business practices of insurers licensed to conduct the business of insurance in the State of Arizona. The Examiners conducted the examination of the Company in accordance with Arizona Revised Statutes (A.R.S. §§20-142, 20-156, 20-157, 20-158, and 20-159. The findings in this report, including all work products developed in the production of this report, are the sole property of the Department.

The examination consisted of a review of the following components of the Company’s annuity business:

1. Provide a proper “free look period” for annuity contracts.
2. Communicate all of the required disclosures relative to annuity contracts.
3. Use of proper replacement practices.

SCOPE AND METHODOLOGY

The examination of the Company was conducted in accordance with the standards and procedures established by the National Association of Insurance Commissioners (NAIC) and the Department. The targeted market examination of the Company covered the period from October 1, 2004 through March 31, 2005 for the business reviewed. The purpose of the examination was to determine: (1) if the Company uses annuity applications and contracts that contain the appropriate notice regarding Free Look and premium refund requirements; (2) if the Company utilizes annuity replacement procedures and practices, and provides training to its producers that complies with the applicable statutes; (3) if the Company uses compliant procedures for processing annuity refunds requested during the Free Look and 30 day option period; and (4) if the Company provides the required disclosure documents, buyer’s guide and annual reports on all annuity applications in compliance with the applicable statutes. This examination targeted the top 75% of the Arizona individual life and annuity insurance market.

The Examiners utilized both examinations by test and examination by sample. Examination by test involves review of all records within the population, while examination by sample involves the review of a selected number of records from within the population. Due to the small size of some populations examined, examinations by test and by sample were completed without the need to utilize computer software.

File sampling was based on a review of life and annuity new business files that were systematically selected by using Audit Command Language (ACL) software and computer data files provided by the Company's Representative, David den Boer, Senior Vice President, and Chief Compliance Officer. Samples are tested for compliance with standards established by the NAIC and the Department. The tests applied to sample data will result in an exception ratio, which determines whether or not a standard is met. If the exception ratio found in the sample is, generally less than 5%, the standard will be considered as "met". The standard in the areas of procedures, forms and policy forms use will not be met if any exception is identified.

EXECUTIVE SUMMARY

This examination was completed by applying tests to each examination standard to determine compliance with the standard. Each standard applied during the examination is stated in this report and the results are reported beginning on page eight.

The Company failed Standard 1 because:

1. It failed to have procedures in place to provide applicants with the right to return annuity contracts within ten days from the date of the delivery of the contract or within 30 days from the date of the delivery of the contract if 65 or older on the date of the application.
2. It used 16 annuity application forms and four annuity contract forms that failed to contain a Free Look Notice prominently printed on or attached to the first page of the application or contract that included: a) a statement to the effect that contract holders age 65 or older have 30 days to return the annuity contract for a full refund of all monies paid; or b) a statement notifying contract holders that, upon written request, the insurer is required to provide within reasonable time reasonable factual information regarding the benefits and provisions of the annuity contract to the contract holder.

The Company failed Standard No. 3 because:

1. It failed to have a procedure in place to detect replacement transactions that have not been reported as such by the applicant or insurance producer.
2. It failed to have the capacity to monitor each producer's policy and contract requirements and produce, upon request, and make available to the department the number of transactions that are unreported replacements of existing contracts detected by the Company's monitoring system.
3. It failed to have procedures in place to notify the applicant, within 10 days of the issuance of the contract, that the producer made a representation that only approved sales materials were used and that the producer provided copies to the applicant.
4. It utilized letters to contract owners, upon receipt of a replacement notice from another insurer, which failed to contain information which advised the contract owner of the right to receive information about the existing policy or contract values, including, if available, an in-force illustration or a policy summary if an in-force illustration cannot be produced.
5. It failed, when persons applied for contracts in response to direct response solicitations, to comply with the requirements of section A.R.S. § 20-1241.05, subsections C and D and the requirements of section A.R.S. § 20-1241.05, subsections E and F.
6. It failed on 12 annuity external and internal replacement applications to notify the applicant that the producer made a representation that only approved sales materials were used and that the producer had provided copies to the applicant.

The Company failed Standard No. 5 because:

1. The Company failed, on solicitations for annuity contracts provided in other than a face to face meeting, to include a statement that the proposed applicant may contact the Company for a free annuity buyer's guide.
2. It issued quarterly and annual statements to contract owners which failed to contain the cash surrender value at the end of the previous report period and at the end of the current report period.

The Company passed Standards Nos. 2 and 4.

STANDARD 1

The following Annuity Replacement and Disclosure Standard Failed:

#	STANDARD	Regulatory Authority
1	Company annuity application and policy forms contain compliant notices concerning the policyholder's right to request benefit and contract provision information and the right to return the contract for a refund of premium.	A.R.S. § 20-1233(A), (B) & (C)

The Examiners reviewed AIG's annuity application and policy forms to determine if those forms contained notices that state the policyholder's right to request information regarding benefit and contract provisions, and the right to return the contract for a refund of premium.

Procedures Performed:

During the Phase I Examination, the Examiners reviewed 18 annuity application forms, 26 annuity contract forms and a random sample of 32 of 1,071 AIG annuity new business application files.

Finding:

During the Phase I portion of the examination, in response to the Department's inquiry, it was determined that the Company failed Standard 1 because the Company failed to have procedures in place to provide applicants with the right to return annuity contracts within ten days from the date of the delivery of the contract or within 30 days from the date of the delivery of the contract if 65 or older on the date of the application.

The Examiners issued a preliminary finding on 11 annuity application forms and four annuity contract forms that failed Standard 1. These forms failed to contain a Free Look Notice prominently printed on or attached to the first page of the application or contract that included:

1. A statement to the effect that contract holders age 65 or older have 30 days to return the annuity contract for a full refund of all monies paid, or
2. A statement notifying contract holders that, upon written request, the insurer is required to provide within reasonable time reasonable factual information regarding the benefits and provisions of the annuity contract to the contract holder.

During their review of 32 annuity files the Examiners identified five additional annuity application forms that failed to contain the required notices.

Form Number	Form Number
FBDA (C)-02-MVA(PG)-AZ	FBDA (C)-01-MVA (1,6)
FBDA (C)-03-CCP	A52-93-AZ
AP68-00	A132-99-AZ
FBDA(C)-00-A-(MYG)-WS	A85-96-AZ
FBDA (C)-01-MVA (S1MVA)-AZ	A168-02-AZ
FBDA (C)-00-A-(MYG)	FBDA(C)-02-MVA-(PG)
FBDA (B)-02-WAMU	AP63-95-AZ
FBDA (B)-00-A	Not Available in File (File 2-05)
FBDA (C)-99-A-AZ	FBDA (C)-00-A-(MYG)(AP#)
FBDA(C)-02	FBA(C)-00-A

ANNUITY CONTRACTS AND APPLICATION FORMS

Number of Exceptions	Population Reviewed	Percentage	Applicable Statute
1	Company Procedures	N/A	A.R.S. § 20-1233(A)
20	Application and Contract Forms	N/A	A.R.S. §20-1233(A)

Recommendation No. 1

Within 90 days of the filed date of this report, provide documentation that procedures and controls are in place to ensure that the Company: a) provides applicants with the right to return annuity contracts within ten days from the date of the delivery of the contract or within 30 days from the date of the delivery of the contract if 65 or older on the date of the application; and b) uses annuity application forms and annuity contract forms that contain a compliant Free Look notice.

STANDARD 3

The following Annuity Replacement and Disclosure Standards Failed:

#	STANDARD	Regulatory Authority
3	Company rules pertaining to producer and company replacement requirements are in compliance with applicable statutes, rules and regulations.	A.R.S. § 20-1241.02; 20-1241.04, 20-1241.05, 20-1241.06, and 1241.07.

The Examiners reviewed AIG's procedures pertaining to producer and Company requirements in connection with replacement of annuity contracts.

Procedures Performed:

During the Phase I Examination, the Examiners reviewed the information provided by the Company in response to the Coordinator's Handbook Attachments A and B, Interrogatories, and follow-up requests.

The Examiners reviewed a random sample of 22 of 987 AIG annuity new business application files selected from the issued new business, external replacement new business and internal replacement new business populations.

Finding:

During the Phase I portion of the examination, in response to the Department's inquiry, it was determined that the Company failed Standard 3 because the Company failed to maintain a system for supervision and control of insurance producers which included a procedure to detect replacement transactions that have not been reported as such by the applicant or insurance producer.

During the Phase I portion of the examination, in response to the Department's inquiry, it was determined that the Company failed Standard 3 because the Company failed to have the capacity to monitor each producer's policy and contract requirements and produce, on request, and make available to the department the number of transactions that are unreported replacements of existing policies or contracts detected by the Company's monitoring system.

During the Phase I portion of the examination, in response to the Department's inquiry, it was determined that the Company failed Standard 3 because the Company failed to have procedures in place to notify the applicant within ten days of the issuance of the contract:

a) That the producer made a representation that only approved sales materials were used during the sales presentation and that copies were left with the applicant.

b) To provide the applicant with a toll free number to contact insurer personnel responsible for regulatory compliance if the insurance producer did not leave sales materials...

c) To advise the applicant that it is important to retain copies of the sales material for future reference.

During the Phase I portion of the examination, in response to the Department's inquiry, it was determined that the Company failed Standard 3 because the Company failed, upon receiving a replacement notice from another insurer with respect to annuity replacements, to send its contract owners, within five business days of receiving the replacement notice, a letter advising the owner of the right to receive information about the existing policy or contract values. The Company produced samples of nine letters (Attachment A, Request IIIA1h) sent to contract owners upon receiving a replacement notice with respect to Annuity Replacements. These letters failed to contain information which advised the owner of the right to receive information about the existing policy or contract values, including, if available, an in-force illustration or a policy summary if an in-force illustration cannot be produced.

During the Phase I portion of the examination, in response to the Department's inquiry, it was determined that the Company failed Standard 3 because the Company failed, when persons apply for contracts in response to direct response solicitations, to comply with the requirements of section A.R.S. § 20-1241.05, subsections C and D and the requirements of section A.R.S. § 20-1241.05, subsections E and F.

Ten of ten (100.0%) annuity internal replacement files and two of two (100.0%) internal replacement files failed Standard 3 because the Company failed to notify the applicant within ten days of the issuance of the contract:

a) That the producer made a representation that only approved sales materials were used during the sales presentation and that copies were left with the applicant.

b) To provide the applicant with a toll free number to contact insurer personnel responsible for regulatory compliance if the insurance producer did not leave sales materials...

c) To advise the applicant that it is important to retain copies of the sales material for future reference.

COMPANY AND PRODUCER REQUIREMENTS REGARDING REPLACEMENT

Number of Exceptions	Population Reviewed	Percentage	Applicable Statute
1	Company Procedures	N/A	A.R.S. § 20-1241.04(B)(5)
1	Company Procedures	N/A	A.R.S. § 20-1241.04(C)(4)
1	Company Procedures	N/A	A.R.S. § 20-1241.05(G)(2)
9	Forms	N/A	A.R.S. §20-1241.06(A)(2)
1	Company Procedures	N/A	A.R.S. § 20-1241.07(B)(1)
12	12	100.0%	A.R.S. § 20-1241.05(G)(2)

An error ratio greater than 5% does not meet standards; therefore recommendations are warranted.

Recommendation No. 2

Within 90 days of the filed date of this report, provide documentation that procedures and controls are in place to ensure that the Company: a) maintains a system for supervision and control of insurance producers which includes a procedure to detect replacement transactions that have not been reported as such by the applicant or insurance producer; b) monitors each producer’s policy and contract requirements and is able to produce, on request, and make available to the department the number of transactions that are unreported replacements of existing policies or contracts; c) notifies applicants, within ten days of the issuance of the contract, that the producer made a representation, that only approved sales materials were used and that the producer provided copies to the applicant; d) sends contract owners, within five business days of receiving a replacement notice, a letter advising the owner of the right to receive information about the existing contract values including, if available, an in-force illustration or a policy summary if an in-force illustration cannot be produced; and e) complies with the requirements of section A.R.S. § 20-1241.05, subsections C and D and the requirements of section A.R.S. § 20-1241.05, subsections E and F when persons apply for contracts in response to direct response solicitations.

Subsequent Events

The Company provided a copy of the "Important Notice" which they began sending in November of 2005 to each Arizona contract owner who purchases a replacement contract, within ten days of the date that the Company issues the contract, to comply with the requirements of A.R.S. § 20-1241.05(G)(2)

The Company provided a copy of the letter which they are sending to contract owners within five business days of receiving a replacement notice to comply with the requirements of A.R.S. § 20-1241.06(A)(2).

The Company provided a draft copy of procedures that it has implemented to detect unreported replacements to comply with the requirements of A.R.S. § 20-1241.04(B)(5).

STANDARD 5

The following Life Insurance and Annuity Replacement and Disclosure Standard

Failed:

#	STANDARD	Regulatory Authority
5	Company rules pertaining to providing disclosure documents, buyer's guides, and annual reports to contract owners are in compliance with applicable statutes, rules and regulations.	A.R.S. § 20-1242.02 and 20-1242.03.

The Examiners reviewed AIG's procedures regarding the Company providing compliant disclosure documents, buyer's guides and annual reports to contract owners.

Procedures Performed:

The Department's procedures included a review of the information provided by the Company in response to the Coordinator's Handbook Attachments A and B, Interrogatories and follow-up requests sent to the Company by the examiner regarding the Attachment A and B materials.

Finding:

During the Phase I portion of the examination, in response to the Department's inquiry, it was determined that the Company failed Standard 5 because the Company failed, on solicitations for annuity contracts provided in other than a face to face meeting, to include a statement that the proposed applicant may contact the Company for a free annuity buyer's guide.

During the Phase I portion of the examination, in response to the Department's inquiry, it was determined that the Company failed Standard 5 because the Company issued quarterly and annual statements which failed to contain the cash surrender value at the end of the previous report period and at the end of the current report period.

COMPANY AND PRODUCER REQUIREMENTS REGARDING REPLACEMENT

Number of Exceptions	Population Reviewed	Percentage	Applicable Statute
1	Company Procedures	N/A	A.R.S. §20-1242.02(E)
1	Company Procedures	N/A	A.R.S. §20-1242.03

Recommendation No. 3

Within 90 days of the filed date of this report, provide documentation that procedures and controls are in place to ensure that the Company: a) includes a statement to the proposed applicant, on solicitations for annuity contracts provided in other than a face to face meeting, which includes a statement that the proposed applicant may contact the Company for a free annuity buyer's guide; c) provides quarterly and annual statements to contract owners of annuity contracts which contain the cash surrender value at the end of the previous report period and at the end of the current report period.

SUMMARY OF STANDARDS

#	STANDARD	PASS	FAIL
1	Company annuity application and policy forms contain compliant notices concerning the policyholder's right to request benefit and contract provision information and the right to return the contract for a refund of premium.		X
2	Company producer training procedures and materials regarding replacement of existing coverage are in compliance with applicable statutes, rules and regulations.	X	
3	Company rules pertaining to producer and company replacement requirements are in compliance with applicable statutes, rules and regulations.		X
4	Company procedures for processing refunds under the "Free Look" option, or the 30 day option, if the application involved replacement of existing coverage, are in compliance with applicable statutes, rules and regulations.	X	
5	Company procedures that require disclosure documents, buyer's guides and annual reports be provided to contract owners are in compliance with applicable statutes, rules and regulations.		X