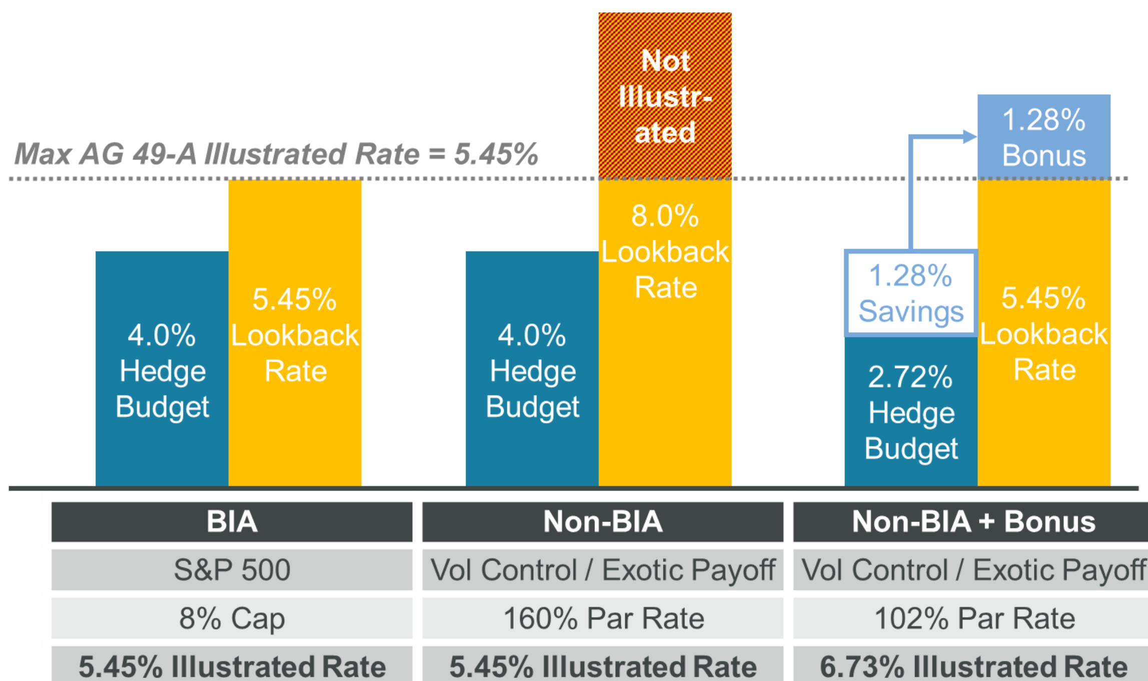
Fred,

We commend the IUL Illustrations Subgroup for once again addressing the issue of potential abuses in Indexed UL illustrations and appreciate the opportunity to comment. While AG 49-A was extremely effective at limiting the specific illustrated impacts of buy-up caps and multipliers, it left open other strategies to augment illustrated performance beyond what was intended by the Subgroup. We are disappointed – but not surprised – that many life insurers have pursued the particular strategy that was described during the Fall LATF meeting of combining "volatility-controlled funds" with a fixed interest bonus to augment illustrated performance.

**Overview of the Strategy to Increase Illustrated Performance**

One of the core tenants of AG 49-A is that the illustrated crediting rate for any indexed account should be limited to the illustrated crediting rate for the Benchmark Index Account (BIA). However, AG 49-A allows for the addition of fixed interest bonuses to the illustrated crediting rate and to illustrated loan arbitrage. It also prescribes that the illustrated rate for any non-BIA account be determined by the same methodology as the BIA – which is the hypothetical historical lookback methodology described in Section 4.

However, using the hypothetical historical lookback methodology, some indexed strategies generate higher illustrated rates than others while having the same hedge costs. In other words, the illustrated "option profits" for these strategies are higher than the BIA. Therefore, life insurers can *reduce* the hedge cost of a non-BIA account so that the illustrated rate matches the BIA and then redeploy the savings into a fixed interest bonus. The fixed interest bonus is then added to total illustrated crediting rate for the account. A step-by-step diagram of the strategy is shown in the graph below using hypothetical figures:




| BIA | Non-BIA | Non-BIA + Bonus |
|---|---|---|
| S&P 500 | Vol Control / Exotic Payoff | Vol Control / Exotic Payoff |
| 8% Cap | 160% Par Rate | 102% Par Rate |
| **5.45% Illustrated Rate** | **5.45% Illustrated Rate** | **6.73% Illustrated Rate** |

The net result is that this strategy is a fully AG 49-A compliant, zero-cost way to augment the illustrated performance of a non-BIA account (or a subset of accounts) beyond the maximum BIA illustrated rate. However, it is not the only way to augment illustrated performance of non-BIA accounts under AG 49-A, as we detailed in our 2020 letter (below) to the Subgroup. We are concerned that if the Subgroup addresses only this particular strategy, life insurers will simply move on to other, more nuanced but no less effective strategies.

It is also important to note that this strategy is the *opposite* of the multiplier strategies defended by some life insurers during the last inquiry in that it reduces option exposure – rather than increases, as with a multiplier – in order to augment illustrated performance. Under the assumption of perpetual, sustainable and structural "option profits" that has long been propagated by some life insurers, reducing exposure to options is actually a detriment to policyholder performance – despite the fact that, under AG 49-A, it produces *better* illustrated performance.

**The Current State of Indexed UL Illustrations**

To demonstrate the current state of the market and the impact of this strategy on illustrated performance, the benchmark below shows illustrated income figures for the life insurers who combine fixed interest bonuses with specific indexed crediting strategies. The benchmark figures are based on a 45-year-old Preferred Male with $1 million in premium being paid over 7 years and income (using indexed loans) being taken from years 21 to 40. The S&P 500 account is the BIA, if offered, or the account that most closely resembles the BIA if the BIA is hypothetical and not available for allocation.

| Carrier | S&P 500 Illustrated Rate | Non-BIA Illustrated Rate | Non-BIA Illustrated Bonus | Non-BIA Combined Rate | S&P 500 Illustrated Income | Non-BIA Illustrated Income | Non-BIA Income Increase |
|---|---|---|---|---|---|---|---|
| A | 5.95% | 6.24% | 2.65% | **8.89%** | 156,548 | 251,083 | **60.4%** |
| B | 5.51% | 5.70% | 1.00% | **6.70%** | 150,934 | 222,040 | **47.1%** |
| C | 5.05% | 5.05% | 1.50% | **6.55%** | 109,585 | 158,126 | **44.3%** |
| D | 5.44% | 6.15% | 0.65% | **6.80%** | 170,488 | 229,307 | **34.5%** |
| E | 7.47% | 7.16% | 1.00% | **8.16%** | 251,241 | 330,898 | **31.7%** |
| F | 6.15% | 6.00% | 0.90% | **6.90%** | 173,657 | 228,166 | **31.4%** |
| G | 5.18% | 5.71% | 0.35% | **6.06%** | 173,714 | 208,934 | **20.3%** |
| H | 6.20% | 6.20% | 0.65% | **6.85%** | 198,779 | 236,268 | **18.9%** |

It is readily apparent from the last column in the preceding table that combining a non-BIA account with a fixed interest bonus is a powerful tool for augmenting illustrated performance under AG 49-A. The percentage increases in income are broadly equivalent to what was seen in the market using buy-up caps and multipliers prior to AG 49-A, the subject of the last round of inquiry and action by the Subgroup. This is not a matter of a "minor" tweak or the need for disclosure.

**The Role of "Volatility-Controlled Funds"**

Any index or payoff structure with higher illustrated "option profits" than the BIA, including "volatility-controlled funds," will allow the life insurer to execute a strategy using a fixed interest bonus that increases the illustrated performance of a non-BIA account beyond what is illustrated in the BIA. While there may be merits (or demerits) to the particulars of "volatility-controlled funds," the fact is that these funds/indices are not a necessary ingredient to executing the strategy and augmenting illustrated performance. They are simply the easiest, most consistent and likely most profitable way.

Further, there are several life insurers in market who offer "volatility-controlled funds" without fixed interest bonuses. These life insurers illustrate the "volatility-controlled funds" at the same overall performance as the BIA, which is consistent with the intent of AG 49-A. Therefore, in our view, the nature of "volatility-controlled funds" should be outside the scope of this discussion. Instead, our view is that the Subgroup would be best served by focusing on the particular strategy by which some life insurers are using non-BIA account specific bonuses to augment illustrated performance in ways that were not intended by AG 49-A.

**Potential Solutions**

We strongly recommend that the Subgroup consider following through on its previously stated commitment to explore a holistic and permanent solution in the event that the Subgroup is reconvened to address yet another issue facing Indexed UL illustrations.

We continue to believe, as we detailed in our 2020 letter appended below, that an illustration methodology for Indexed UL rooted in standard fair-market option valuation – a methodology used the world over by option practitioners – will produce a framework that cannot be meaningfully gamed and will produce more consistent, consumer-friendly and economically indicative results than the current AG 49 / AG 49-A framework.

Again, thank you for the opportunity to comment and we look forward to working with the Subgroup to implement a lasting solution for Indexed UL illustrations.

Coalition of Concerned Insurance Professionals

Signed (alphabetically):

Barry Flagg, President, Veralytic
Ben Baldwin Jr
Bill Boersma, President, OC Consulting Group
Bobby Samuelson, Executive Editor, The Life Product Review
Chris Hause, FSA, President, Hause Actuarial Solutions
Jerry Vanderzanden, Insurance Fiduciary
Larry Rybka, President & CEO, Valmark Financial Group
Richard M. Weber, President, The Ethical Edge, Inc
Scott Witt, FSA, President, Witt Actuarial Services
Steven Roth, President, Wealth Management International, Inc, Licensed Life & Disability Insurance Analyst
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**Letter submitted to IUL Illustration Subgroup on 2/21/2020**

Fred,

Thank you for the opportunity to comment on potential revisions to AG49. While we see merits in the Supplemental Option Budget approach, we believe that it is unable to address the full spectrum of designs that could lead to effective illustrated rates well in excess of the AG49 maximum illustrated rate for the Benchmark Index Account (BIA). For example, it is not effective for dealing with the implications of alternative crediting strategies and hybrid indices that have higher imputed option profits based on the hypothetical historical lookback methodology in AG49 Section 4(A), which already provide for means of illustrating returns well in excess of the BIA maximum illustrated rate in products available for sale today. It is also not clear how the concept of a Supplemental Option Budget would interact with persistency funded multipliers, bonuses or cash infusions, as are commonly found on Indexed UL products currently in market.

As a result, we believe that alternatives to the Supplemental Option Budget approach should be considered that will better align Indexed UL illustrations to Fixed Indexed Annuity illustrations and address the full spectrum of potential indexed crediting and product designs. This letter outlines an alternative methodology with specific AG49 language recommendations. We believe that the changes we are proposing to AG49 will accomplish the goals set forth by the regulators while maintaining the ability for life insurers to clearly differentiate crediting strategies and products on the basis of risk and return characteristics using historical index return data.

Our recommendation is for two primary modifications to AG49. The first is to move the hypothetical historical lookback methodology currently used in 4(A) to the crediting rate reports described in Section 7. We also recommend that Section 7 be augmented to encompass best case, worst case and most recent case historical returns over 10 years, aligning Indexed UL illustrations with Fixed Indexed Annuity illustrations. Finally, we recommend that Section 7 be clarified to allow any additional credits or charges contractually related to providing indexed interest which, again, is in accordance with Fixed Indexed Annuity illustrations. Taken together, these changes will augment the insurer's ability to show how variability of returns can impact crediting performance in a variety of scenarios for each indexed crediting option, thereby increasing consumer understanding of the crediting mechanics and potential risks and returns of the strategies.

Second, we recommend using an option valuation methodology for Section 4(A) with pricing inputs being drawn from the previous calendar year. We recommend using the Black-Scholes formula, a universally accepted valuation methodology for derivatives, including call options, and is commonly applied to the valuation of financial products containing derivatives-based payoffs, such as warrants and retail structured products. Replacing 4(A) with an option valuation formula aligns the maximum illustrated rate with the denominator for all indexed-linked credits in the contract, regardless of whether they are funded through the insurer's portfolio yield, additional policy charges or persistency. This modification to 4(A) will eliminate the illustrated benefits of multipliers and buy-up caps.

It would also align the illustrated benefits of alternative crediting strategies and hybrid indices with the Benchmark Index Account. There would be differences in the illustrated rates for the various accounts based solely on the fair market value of the options, which is a true and reasonable indicator to consumers of the current intrinsic value of the indexed crediting option. However, consumers would still be able to see the potential risks and rewards of these strategies in the hypothetical historical crediting reports described in Section 7 based on historical index returns. By combining these two approaches, consumers will be able to make an informed decision about choosing an indexed crediting strategy based on both the current fair-market valuation

of the replicating options for the strategy (Section 4(A)) and its potential to deliver performance in a variety of historical return scenarios (Section 7).

The changes to the AG49 language proposed herein would accomplish the following goals stated by regulators:

1. Standardizing illustrated rates across Benchmark Index Account options, in accordance with the stated goals of the original Indexed UL Illustration Subgroup in 2013.
2. Limiting the ability for alternative crediting strategies and indices to illustrate more advantageously than traditional indices and crediting strategies, in accordance with the stated goals of the original subgroup.
3. Ensuring that products with multipliers illustrate similarly to products without multipliers, in accordance with the recent vote taken by the IUL Illustration Subgroup.
4. Ensuring that products with buy-up caps illustrate similarly to products without buy-up caps, in accordance with the vote taken at the most recent NAIC meeting in Austin.
5. Bringing Indexed UL illustrations into alignment with Fixed Indexed Annuity illustrations.
6. Maintaining of the majority of the current AG49 language, including the 145% factor for illustration actuary testing, thereby avoiding a time-intensive rework of the guideline.

The language proposed herein would also satisfy the following concerns raised by life insurers:

1. Continuing to provide for the ability of life insurers to differentiate their products and crediting methodologies by demonstrating the potential for different indexed crediting options to offer different risk/return profiles, including multipliers, buy-up caps and proprietary/hybrid indices.
2. Providing for illustrated loan arbitrage to a similar degree as Whole Life, thereby ensuring that Indexed UL is not at a competitive disadvantage to Whole Life in terms of illustrated loan treatment.
3. Providing for the continued illustration of persistency-based, embedded multipliers and bonuses, thereby ensuring that Indexed UL is not at a competitive disadvantage to other types of Universal Life products.

Specific AG49 language changes, with accompanying comments, are appended. We appreciate the opportunity to comment and respectfully submit our proposal.

Signed,

Bobby Samuelson, Executive Editor, The Life Product Review
Larry Rybka, President & CEO, Valmark Financial Group
Joseph M. Belth, professor emeritus at Indiana University
Chris Hause, FSA, President, Hause Actuarial Solutions
Richard M. Weber, President, The Ethical Edge, Inc
Barry Flagg, President, Veralytic
Stephen R. Leimberg, Publisher, Leimberg Information Services, Inc
Bill Boersma, President, OC Consulting Group
Tom Love, VP, Insurance Analytics, Valmark Financial Group
Mike Brohawn, President, Your Life Insurance Solution
Steven Roth, President, Wealth Management International, Inc., Licensed Life & Disability Insurance Analyst
Ben Baldwin Jr

**Suggested AG49 Language Modifications**

1. Replace 4(A) with:

    A. Calculate the value of the replicating option trades for the Benchmark Index Account over the preceding calendar year, based on the Black-Scholes formula using the following inputs calculated on each trading day:
        i. Average closing implied volatility for 12-month, at-the-money S&P 500 call options
        ii. Average closing implied volatility for out-of-the-money 12-month S&P 500 call options with a normalized strike price equal to the currently declared cap
        iii. Average dividend yield on the S&P 500
        iv. Average 12-month LIBOR

    *This section is designed to replicate the reasonable price of replicatively hedging the current index parameters in the Benchmark Index Account. An alternative approach may be for the NAIC to publish standard tables of the estimated price for hedging index participation parameters at defined intervals (0.25%, for example) with allowance for insurers to interpolate between the datapoints. This would limit the degree to which insurers with identical index participation parameters would have different illustrated performance. LIBOR may also be exchanged for another measure of Risk Free Rates.*

2. Replace 4(B) with:

    B. The value calculated in 4(A) shall be the maximum credited rate(s) for the illustrated scale.

3. Remove 3(A) – The Alternate Scale

4. Replace 4(C) with:

    C. For other Index Accounts using other equity, bond, and/or commodity indexes, and/or using other crediting methods, the illustration actuary shall use actuarial judgement to determine the maximum credited rate for the illustrated scale. The determination shall reflect the fundamental characteristics of the Index Account as relates to the inputs for the Black-Scholes valuation formula, including realized volatility, implied volatility, volatility targets (if applicable), embedded fees (if applicable), deduction of an interest rate component (if applicable), dividend participation (if applicable) and other factors that may apply.

    *This section is designed to ensure that products using different crediting methodologies, indices or combinations of the two illustrate in the same methodology as the Benchmark Index Account in accordance with their fundamental, underlying characteristics*

5. Replace 7 with the following:

A. A table showing the minimum and maximum of a geometric average for any available Benchmark Index Account using the following methodology:
   i. Calculate the geometric average annual credited rate for each applicable Benchmark Index Account for the 25-year period starting on 12/31 of the calendar year that is 66 years prior to the current calendar year (e.g., 12/31/1949 for 2015 illustrations) and for each 25-year period starting on each subsequent trading day thereafter, ending with the 25-year period that ends on 12/31 of the prior calendar year.
   ii. Calculate the arithmetic average of the geometric average annual returns in all 25-year periods

B. For each Index Account illustrated, a table showing actual annual historical index changes and corresponding hypothetical interest rates using current index parameters, including any applicable asset-based charges and asset-based interest bonuses or index credit multipliers paid within the first 10 years of the policy:
   i. The 10-year period with the lowest calculated returns within the period referenced in 7(A)(i)
   ii. The 10-year period with the highest calculated returns within the period referenced in 7(A)(i)
   iii. The most recent 10-year historical period as calculated on the final trading day of the preceding calendar year

C. If an index has not been in existence for 10 years, the table shall replace the figures with the maximum available back-tested performance.

   *This section is designed to bring Indexed UL illustrations into alignment with Fixed Index Annuity illustrations. These demonstrations will also provide latitude for insurers to demonstrate the potential risk and return profiles of various crediting strategies, indices and policy mechanisms.*

The following sections of AG49 were not altered for the following reasons:

5. There is no need to change the 145% provision in 5(A) as it will provide a cushion for the inevitable mismatches between the standardized illustrated price of the replicating options calculated in 4(A) and the insurer's own pricing for options, expectations of prices or cap-setting process. Retaining the 145% will allow insurers who have economies of scale in hedging, are supporting higher caps with higher policy charges or other designs to illustrate benefits and costs accordingly. However, it may be advisable to adopt some of the clarifications to this language previously proposed in other comment letters.

6. There is no need to change the 100 basis points allowance for illustrated loan arbitrage. As with Section 5, there are inevitable mismatches between what an insurer is willing to charge on a loan and the value of what it may credit by providing current index participation parameters. This section preserves the ability for insurers to reflect those changes. However, it may be prudent to add clarifying language about the inclusion of illustrated bonuses and multipliers for the 100bps allowance.