AG49 Comment Letter

Mr. Fred Andersen

Chair, NAIC IUL Illustration (A) Subgroup

Re: ACLI proposed draft of Actuarial Guideline 49-A

Dear Mr. Andersen:

Equitable appreciates the opportunity to submit this follow-up to our proposal regarding AG49-A on prospective requirements for IUL illustrations.

This follow-up proposal integrates select elements of the Independent and Equitable proposals into the ACLI proposal structure. The resultant “Integrated Proposal” leverages the effort to develop the ACLI proposal but adjusts features required to satisfy our understanding of regulator objectives – including several valid concerns raised by non-ACLI commentators about the ACLI proposal that, if not addressed, jeopardize the durability of the AG49 revisions. Critical features of the Integrated Proposal are its greater clarity and simplicity.

A draft of the Integrated Proposal, redlined from the ACLI proposal, is attached for reference.

The remainder of this letter is organized to accomplish the following objectives:

1- Articulate our (refined) understanding of the regulator governance objectives

2- Propose an “integrated proposal” that accomplish regulator objectives

3- Suggest next steps for regulators to finalize AG49 revisions

I. Our (refined) understanding of the IUL illustration governance objectives

The stated goals of AG 49 are to (i) guide the determination of maximum illustrated crediting rates and earned interest rates for the disciplined current scale and (ii) require additional side-by-side illustrations and disclosures to aid consumer understanding. As noted in our prior letter, we believe this reflects the overarching regulator desire to ensure policy illustrations depict a realistic projection of long-term policyholder returns upon which a current or prospective policyholder can establish realistic expectations for account performance and funding requirements.

From a technical perspective, we bifurcate the elements of the illustration that require governance into the:

a) Size of the “option budget”: the amount of total contract value “put at risk” by investing in equity options or other risky investments.


b) **Rate-of-return on the “option budget”:** the illustrated long-term return of the instruments in which the option budget is invested.

**Figure 1:** Elements of the IUL illustrated return and associated regulator concerns

**Element 1: Size of the option budget**

- **Regulator concern #1:** NEW
  - Current NIERs overstate long-term NIERs given low reinvestment yields

- **Regulator concern #2:**
  - Excess charges allocated to risky instruments can lead to rapid account underperformance

**Element 2: Rate-of-return of option budget investments**

- **Regulator concern #3:**
  - Illustrated rate-of-return on option budget investments exceeds long-run realistic expectations, fails to consider downside case

With respect to the **size** of the option budget, we understand the foremost regulator concern to be option budgets that are substantially larger than what can be supported by investing the contract value at yields on prevailing high-quality investments – especially given the expected decline of current portfolio NIERs given far lower prevailing investment yields. This concern has not been addressed by the ACLI proposal, which was developed before interest rates declined to their present level and the examples for which continue to reflect assumed NIERs of 4.5%.

With respect to the **rate-of-return** on the option budget, we understand the foremost regulator concern to be illustrated returns well in excess of high grade investment yields – i.e. overly optimistic assumptions about the realization of market risk premia.

These concerns manifest in the ultimate regulator concern that consumers predicate decisions on unrealistic expectations of contract performance, irrespective of whether the option budgets themselves are overstated or the rate-of-return on the option budget are overstated.

**II. Proposed “Integrated Solution”**

In order to address these concerns in a manner that builds upon the time and thought invested into the ACLI proposal, Equitable proposes to integrate elements of the Independent Proposal and prior Equitable proposal into the ACLI proposal structure. The table below summarizes the principal adjustments to the ACLI proposal that we believe are necessary to accomplish the regulator objectives. The table includes a description and rationale for each adjustment.
The key beliefs behind the Integrated Proposal adjustments to the ACLI proposal are below:

- **Past performance is no guarantee of future returns**: The Integrated Proposal reduces the reliance on backtesting to forecast long-term future returns. Equitable believes backtesting of a given strategy can be part of the product sale process – as reflected in the section 7 table of historical index returns – but has a limited role in the illustration of long-term returns given their unproven predictive power for future returns over multiple decades.

- **A 45% annual excess return is an imprudent basis for long-term return expectations**: The Integrated Proposal reduces the maximum long-term realization of risk premia to 20% per year. Equitable believes this level could still be viewed as overly optimistic – but strikes a compromise relative to the existing 45%. To be sure, a 45% annual return over a multi-decade illustration timeframe leads to significant levels of
projected contract outperformance (three-fold account levels over 50 years), as summarized in the table below.

Table I: Long-term accumulated returns of $1 by proposed annual return cap

<table>
<thead>
<tr>
<th>Return cap (5% hedge budget)</th>
<th>Projection length (years)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>30</td>
</tr>
<tr>
<td>100%</td>
<td>4</td>
</tr>
<tr>
<td>120%</td>
<td>6</td>
</tr>
<tr>
<td>145%</td>
<td>8</td>
</tr>
</tbody>
</table>

Of paramount importance to the success of AG49 is that the policyholder expectation for contract performance does not rely on excessive long-run outperformance of the instruments in which the option budget (of whatever size) is invested. The table above demonstrates the considerable outperformance that is assumed in current proposals.

- **The size of the option budget should be governed distinctly from the rate-of-return of the option budget:** The prior belief notes the significant impact of high annual illustrated risk premia. Better governance of the rate-of-return enables more latitude in the illustration of option budgets that rely, in part, on supplemental charges (not investment returns). This view reflects a belief that (a) a policyholder may reasonably seek a contract with greater market exposure than what can be created by an option budget supported only by prevailing yields on high quality investments – and hence who desire a larger option budget and (b) an outsized (e.g. 145%) rate-of-return on the supplemental charges is not illustrated given more strict governance of the rate-of-return.

To reinforce this point, we consider Indexed UL as offering a spectrum between fixed UL and Variable UL – and a VUL policy has a 100% market exposure since all contract value can be invested in equities, far above the proposed 5% cap for IUL illustrations.

- **Standardization of option budget sizes is critical to consistency of illustrations:** The Integrated Proposal embraces the Independent Proposal use of Black-Scholes to determine option budget size. Use of a Black-Scholes methodology will ensure consistent inputs are used to size the illustrated option budgets. The prospect of two companies with substantially similar index crediting features and NIERs that illustrate different returns is an objectionable feature of the ACLI proposal.

- **Black-Scholes is the best available method to ensure consistent option budgets:** Black-Scholes is simply another term for market pricing – and is a practical and robust method to size long-run option budgets. First, Black-Scholes inputs are readily accessible (the ACLI analysis demonstrates this). Second, any market risk premia in Black-Scholes has been demonstrated to be modest over time and, to be sure, any conservatism is far more than offset by the allowance of up to 20% annual excess returns on the option budget investments. Third, any concerns about rate stability year-over-year are irrelevant given (i) rates are, by nature, not stable given fluctuations in market risk from year-to-year and (ii) rate stability has not been identified as a regulator objective.
• **Realistic ‘downside scale’ performance add valuable transparency to consumers:**

The requirement to include an equally prominent, side-by-side illustration of the downside (aka “alternate”) scale that differs only in the rate-of-return of the option budget offers consumers valuable insight into contract performance and potential funding requirements should risk premia not be realized. Holding constant all other elements of the illustration helps to ensure such alternate illustrations are not disregarded as overly conservative by consumers.

III. **Suggested next steps for regulators to close out AG49 revisions**

Equitable believes the Integrated Proposal represents a pragmatic solution that leverages the investment of time in the ACLI proposal with critical adjustments to ensure its durability.

To bring the AG49 revisions to a close we suggest the regulators confirm or reject the concerns outlined in Section I and the associated key beliefs behind the “integrated proposal” in Section II. This will enable a more rapid convergence on the final features of the AG49 revision and use of the Integrated Proposal (practical given it starts with the structure of the ACLI proposal).

Thank you once again for the opportunity to share our thoughts with you on this important issue. Please do not hesitate to contact me should you have any questions or concerns regarding our proposal.

Aaron Sarfatti, ASA  
Chief Risk Officer