

## **INDUSTRY FEEDBACK ON IUL EXPOSURE DRAFTS (10/29/2019 and 11/01/2019)**

Since the LATF straw poll taken on October 17, 2019, insurers have submitted drafts of changes to AG49 that reflect their interpretation of the types of revisions that are needed to support LATF's stated objective: That multiplier products illustrate no higher than non-multiplier products. Those proposed revisions are referred to in this document as the "11/01/2019 Exposure" or "the Nationwide letter", and the "10/29/2019 Exposure."

Despite these and other efforts to produce satisfactory changes to AG49, progress has been hindered because certain key provisions that have been proposed are subject to multiple interpretations over which the industry lacks consensus. The uncertainty over the treatment of buy-up accounts, which was resolved at the NAIC Austin meeting, is just one example of differing interpretations of draft AG49 changes requiring guidance from regulators.

To continue the progress that was made in Austin and move toward producing amendments to AG49 in line with LATF's stated intentions, this document identifies four issues in the proposed language for potential clarification. With respect to each issue we (1) identify the relevant proposed language; (2) describe the possible interpretations; and (3) note the impact each interpretation will have on the illustration. We believe it is critical that any changes to AG49 be clear and unambiguous, which is why receiving clarification from regulators on these provisions is necessary before drafting of changes to the guideline can be finalized.

### **Issue #1. Are either of the current options regarding the Supplemental Option Budget which are meant to restrict the illustration of multiplier and buy-up features acceptable to regulators?**

Two different versions of language addressing the Supplemental Option Budget have been proposed (described in more detail below as "Option A" and "Option B"). While both Option A and Option B achieve much of what LATF intended to accomplish on its October 17, 2019 straw vote, they do so in different ways. Both would still allow for some, albeit significantly smaller, multiplier benefits to be shown. Clarification is needed as to whether regulators have a preference between Option A and Option B, or another approach.

#### **Option A: 11/01/2019 Exposure**

The proposed language provides as follows:

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| 3. <b>G. Supplemental Option Budget:</b> Any asset-based charges or other policy charges that are explicitly used to increase the total amount spent to generate the Indexed Credits of the policy. This amount is expressed as a percent of the policy's indexed account value.                     |
| 4. E. If charges that fund a Supplemental Option Budget are deducted from the illustrated cash value, then Indexed Credits generated by the return from the Supplemental Option Budget within the scenario being illustrated may be illustrated in an amount up to, but not exceeding, such charges. |

**Benefit:** Clearly identifies the Supplemental Option Budget as a charge that is explicitly used to increase the total amount spent to generate Index Credits. It is also clear that any Indexed Credits, by the return from the Supplemental Option Budget, can only ever be as high as the charges themselves.

**Interpretational Issues:** The draft language allows for at least two interpretations, each producing different outcomes:

**Interpretation A:** The draft language does not allow illustration of bonuses other than those funded through NIER to enhance the maximum AG49 values.

**Interpretation B:** The draft language allows a bonus without a charge to enhance the maximum AG49 values since it is already limited by DCS testing as modified in Section 5B.

The differences in interpretation result from the fact that policy charges in general can be used for a variety of purposes. Determining how a charge is being used in every situation could be extremely difficult to ascertain.

What follows are examples of how, working combination with section 5B, this section may still allow for bonuses that take the shape of a multiplier to be illustrated.

**Example 1:** Assuming a cap of 10% and a maximum AG49 lookback of 6.15%, suppose we assume that the cost of such an account is 4.5%. 145% of 4.5% is 6.525%. Based upon those assumptions it would be possible to illustrate a persistency bonus not explicitly funded by charges but which provides a credit expressed as a percentage of index-linked credits and which is supported by hedges. The supporting hedges could increase the earned rate from 6.15% to 6.525% and still comply with this draft language.

**Example 2:** Assume with an option budget of 4.5%, a cap of 10% can be afforded with a multiplier of 0%, resulting in a maximum AG49 lookback rate of 6.15%. The option budget

of 4.5% could alternatively purchase a cap of <10% and a multiplier > 0%, such as a cap of 8% and a multiplier of 15%, resulting in a maximum AG49 lookback rate of 5.15%. The chart below shows the effective illustrated rates for these two indexed accounts.

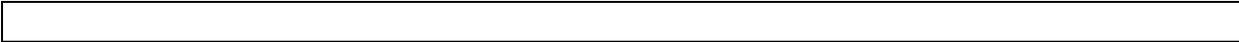
	Index Account 1	Index Account 2
Option Budget	4.5%	4.5%
Supplemental Option Budget	0%	0%
Cap	10%	8%
Multiplier	0%	15%
Max AG49 Lookback Rate	6.15%	5.15%
Effective illustrated rate post multiplier (assuming 3% illustrated rate)	$3\% \times (1 + 0\% \text{ multiplier}) = 3.0\%$	$3\% \times (1 + 15\% \text{ multiplier}) = 3.45\%$
Effective illustrated rate post multiplier (assuming 4% illustrated rate)	$4\% \times (1 + 0\% \text{ multiplier}) = 4.0\%$	$4\% \times (1 + 15\% \text{ multiplier}) = 4.6\%$
Effective illustrated rate post multiplier (assuming max AG49 illustrated rate)	$6.15\% \times (1 + 0\% \text{ multiplier}) = 6.15\%$	$5.15\% \times (1 + 15\% \text{ multiplier}) = 5.92\%$

**Other issues:** Many discussions have centered on the potential issues that defining the Supplemental Options Budget as a charge could create. Policy charges in general can be used for a variety of purposes and it could be difficult to ascertain whether a charge is being used explicitly for the purposes of generating indexed credits. For example, it would be difficult to know whether a portion of COI charges or per 1000 Face Amount charges is being used to increase the option budget. Another example would be that a source other than a charge could be used to fund a supplemental option budget, such as reducing a persistency bonus in later years to fund a supplemental option budget.

**Option B: 10/29/2019 Exposure**

The proposed language provides as follows:

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| <p>3. <u>G. Supplemental Option Budget:</u> The total amount spent to generate the Indexed Credits of the policy minus the Annual Net Investment Earnings Rate. This amount is expressed as a percent of the policy’s indexed account value.</p> |
| <p>4. E. The total Index Credits illustrated shall not exceed the annual earned interest rate underlying the disciplined current scale as defined in 5 (A) and (B).</p>  |



**Benefit:** This version bypasses the issue of where the budget for policy enhancements can come from by tying the maximum illustrated enhancement to the Net Investment Earned Rate. This would help close a potential loophole it is tied to a well-defined metric.

**What it still allows:** In combination with section 5B, this section may still allow illustration of charged for policy enhancements such as multipliers and buy-up accounts. A simple example of this would be to assume a cap of 10% and a maximum AG49 lookback of 6.15. Assume further an earned rate of 4.5% and a hedge cost of 4.5%. 145% of 4.5% is 6.525%.

Here are two examples:

**Example 1:** Given that 4.E. does not mandate that charged for features only credit back the charges, there is an avenue that a charged for multiplier could exist to increase the credit up to 6.525% from 6.15%. The multipliers or buy-up features that result from this difference (6.525% - minus 6.15%) are significantly reduced from the multipliers that exist in the market today. In the example above, the resulting multiplier would be 6% and the charge for such a multiplier could be 27bps of Account Value. Although the enhancements and charges are significantly reduced in this scenario, they would still be illustratable.

**Example 2:** Assume with an option budget of 4.5%, a cap of 10% can be afforded with a multiplier of 0%, resulting in a maximum AG49 lookback rate of 6.15%. The option budget of 4.5% could alternatively purchase a cap of <10% and a multiplier > 0%, such as a cap of 8% and a multiplier of 15%, resulting in a maximum AG49 lookback rate of 5.15%. The chart below shows the effective illustrated rates for these two indexed accounts.

	Index Account 1	Index Account 2
Option Budget	4.5%	4.5%
Supplemental Option Budget	0%	0%
Cap	10%	8%
Multiplier	0%	15%
Max AG49 Lookback Rate	6.15%	5.15%
Effective illustrated rate post multiplier (assuming 3% illustrated rate)	$3\% \times (1 + 0\% \text{ multiplier}) = 3.0\%$	$3\% \times (1 + 15\% \text{ multiplier}) = 3.45\%$
Effective illustrated rate post multiplier (assuming 4% illustrated rate)	$4\% \times (1 + 0\% \text{ multiplier}) = 4.0\%$	$4\% \times (1 + 15\% \text{ multiplier}) = 4.6\%$

Effective illustrated rate post multiplier (assuming max AG49 illustrated rate)	6.15% x (1+ 0% multiplier) = 6.15%	5.15% x (1+ 15% multiplier) = 5.92%
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**Other issues:** Some concerns around the language in 4E should be converted to a return on assets to be comparable to the annual earned interest rate.

**Issue #2: What are the appropriate ways to set the maximum illustrated rate for Index Accounts that have a different risk profile than the Benchmark Index Account?**

This issue relates to the current language in Section 4.C, which states:

For other Index Accounts using other equity, bond, and/or commodity indexes, and/or using other crediting methods, the illustration actuary shall use actuarial judgment to determine the maximum credited rate for the illustrated scale. The determination shall reflect the fundamental characteristics of the Index Account and the parameters shall have the appropriate relationship to the expected risk and return of the applicable Benchmark Index Account. In no event shall the credited rate for the illustrated scale exceed the applicable rate calculated in 4 (B).

**Why guidance is needed:**

Many index accounts have a different risk profile than the Benchmark Index Account. For example, certain index accounts use bonds, cash or commodities or use different crediting methods. AG 49 provides that the maximum illustrated rate for these index accounts is determined using actuarial judgment, subject to two requirements: the maximum illustrated rate (1) shall reflect an appropriate relationship to the expected risk and return of the applicable Benchmark Index Account and (2) shall not exceed the maximum illustrated rate for the Benchmark Index Account. The guideline provides little guidance for the first requirement. Are regulators okay with the fact that assessments of expected risk and return may vary in the industry? As an example, varying assessments could result in maximum illustrated rates that differ between products that have the same index, same crediting method, and same index parameters.

**Issue #3: Clarification is needed as to whether the intent is to limit this to the dollar amount of earnings produced by the GA assets or the interest rate of earnings on the GA assets.**

The direction provided by the IUL Subgroup is that the hedge cost that can assume a 145% return is limited to the earnings on the GA portfolio.

Example:

GA portfolio assets = \$1000

Earned rate on GA portfolio = 5%

Dollar amount of GA earnings = \$50

If the account value also equals \$1000, using the dollar amount or rate allows the same hedge cost of up to \$50 to assume a 145% return, resulting in a hedge return of \$72.50.

However, when the account value is higher or lower than the assets, the two approaches can produce a different result.

Under the dollar amount approach, up to \$50 of hedge cost can assume a 145% return, resulting in a hedge return of \$72.50.

If the account value is \$800, the \$50 hedge cost assuming 145% is 6.25% of the AV ( $\$50 / \$800$ )

If the account value is \$1,200, the \$50 hedge cost assuming 145% is 4.17% of the AV ( $\$50 / \$1,200$ )

Under the interest rate approach, 5% of the account value can assume a 145% return, resulting in different amounts of hedge cost that assumes 145% than the dollar amount earned by the GA assets.

If the account value is \$800, 5% of the account value or \$40 of hedge cost can assume 145%, producing a hedge return of \$58.

If the account value is \$1,200, 5% of the account value or \$60 of hedge cost can assume 145%, producing a hedge return of \$87.

The Nationwide letter dated 11/12/2019 identifies two possible methods of incorporating hedge cost and return in DCS testing (Section 5.B.A) which can produce different results. Guidance is needed as to whether these differences are acceptable.

#### **ISSUE #4 Should any credits, such as a fixed bonus, that are not directly tied to the performance of an index account, be included within the 100 basis point limit?**

Proposed language for section 6.B in the 11/01/2019 Exposure indicates that credits, such as a fixed bonus, that are not tied directly to the performance of an index account, should not be included within the 100 basis point limit:

If the illustration includes a loan, the total index credits to the policy loan balance shall not exceed the interest rate charged to the loan by more than 100 basis points. For example, if the loan charge is 4% of the loan balance, index credits to the loan balance cannot exceed 5%, regardless of product features available.

However, the language above should include the following:

- Incorporating the pre-defined term “Indexed Credits” into the language above. From the “Definition” section of the 11/01/2019 exposure:
  - ***Indexed Credits: Any interest credit, multiplier, factor, bonus, or other enhancement to policy values that is linked directly or indirectly to an index or indices.***
- How to incorporate charges used to fund a Supplemental Option Budget that apply to the loan balance
- Suggested revised language:

If the illustration includes a loan, the total Indexed Credits as a result of the policy loan shall not exceed the illustrated rate charged to the loan by more than 100 basis points. The illustrated rate charged on the loan is inclusive of any asset-based fee or other policy charges used to fund a Supplemental Option Budget. For example, if the illustrated rate charged on the loan is 4% of the loan balance, Indexed Credits as a result of the policy loan cannot exceed 5%, regardless of product features available.

Additionally, there are philosophical differences concerning whether credits, such as a fixed bonus, that are not directly tied to the performance of an index account, ought to be included within the 100 basis point limit. Guidance from regulators is therefore needed regarding the following two options:

**Option #1:** The limit is absolute and therefore should apply to the **total** amounts credited to indexed account (inclusive of any non-indexed bonus).

**Option #2:** The limits should only apply to the credit that is tied to the index performance and the addition of a bonus that is not impacted by index performance should not be affected by the 100 basis point limit.

Once there is clarification around which option is preferred, additional language can be added to increase transparency around the issue.