Fred,

Thank you for exposing the Independent Proposal and providing the opportunity to comment on it.

A Fundamental Misconception about Multipliers and Buy-Up Caps

The Independent Proposal was created and submitted for a very specific reason, but perhaps not the one that the members of the Subgroup or the supporters of the ACLI proposal imagine. For the past 18 months, the Subgroup has been evaluating newly created features of Indexed UL products that appear to circumvent the letter and spirit of the original AG 49. Late last year, the Subgroup took a directional vote that these features, particularly multipliers and buy-up caps, should not provide any illustrated benefits in excess of a base Indexed UL product. The implication from the Subgroup’s vote is that a product with these features should illustrate net performance no better than a product without them.

However, these new features are part and parcel to a base Indexed UL product. In fact, buy-up caps were contemplated by the original AG 49 and determined to be in accord with both the letter and spirit of the guideline. They were specifically accommodated by the allowance for multiple Benchmark Index Accounts. Similarly, multipliers are also consistent with the letter and spirit of the original AG 49 in that they do not augment illustrated performance beyond the applicable BIA rate. See below for a table of examples demonstrating the consistency of both buy-up caps and multipliers with AG 49.

<table>
<thead>
<tr>
<th></th>
<th>BIA 1</th>
<th>Multiplier 1</th>
<th>BIA 2</th>
<th>Multiplier 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Cap</td>
<td>10.00%</td>
<td>8.00%</td>
<td>14.00%</td>
<td>8.00%</td>
</tr>
<tr>
<td>Option Cost</td>
<td>5.05%</td>
<td>4.18%</td>
<td>6.64%</td>
<td>4.18%</td>
</tr>
<tr>
<td>AG 49 Illustrated Rate*</td>
<td>6.20%</td>
<td>5.13%</td>
<td>8.15%</td>
<td>5.13%</td>
</tr>
<tr>
<td>Implicit Charge</td>
<td>0.00%</td>
<td>0.87%</td>
<td>0.00%</td>
<td>0.87%</td>
</tr>
<tr>
<td>Explicit Charge</td>
<td>0.00%</td>
<td>0.00%</td>
<td>1.59%</td>
<td>1.59%</td>
</tr>
<tr>
<td>Multiplier</td>
<td>0.00%</td>
<td>20.81%</td>
<td>0.00%</td>
<td>58.85%</td>
</tr>
<tr>
<td>Net Illustrated Rate</td>
<td>6.20%</td>
<td>6.20%</td>
<td>6.56%</td>
<td>6.56%</td>
</tr>
</tbody>
</table>

*Adjusted so that ratio of Black-Scholes valuation to AG 49 Hypothetical Historical Lookback valuation is constant

Despite claims to the contrary, the companies using multipliers, buy-up caps and other types of product designs were not circumventing or aggressively interpreting AG 49. These companies were, in fact, operating in a manner consistent with the letter and spirit of the original guideline, using the tools specifically provided to them to augment their illustrated performance. The Subgroup is revisiting AG 49 because companies did exactly what the guideline allowed – and even encouraged – them to do. Accomplishing the goals set forth by the regulators regarding multipliers and buy-up caps is not a matter of replacing a faulty heart valve with a new one while keeping the heart itself intact. The guideline is clearly afflicted by a broader disease, of which multipliers and buy-up caps are only some of the symptoms. Limiting the reach of the disease, which is what the ACLI proposes, is only a temporary solution with problematic side effects. The Independent Proposal, by contrast, would permanently cure the disease – quickly, simply and with beneficial side effects for consumers and insurers alike.

The Hypothetical Lookback Methodology in AG 49 Shows Reward, but Not Risk

The source of the disease within AG 49 is readily apparent. The SOA Task Force on illustrations described the incubator for such a virus in their 1992 report by writing that:
It can be seen that Type B usage [that is, usage of illustrations as performance projections] is inappropriate unless the illustration can include a measure of relative risk. For example, if one illustration shows 15% lower premiums but has 60% greater risk of not achieving projected values, then lack of risk disclosure renders the comparison meaningless.

It is well known and an uncontested fact that Type B usage of illustrations is pervasive in the market for all product types, not just Indexed UL. But Indexed UL has a particular advantage for Type B illustration usage that the Task Force clearly describes as “inappropriate” – AG 49 allows for the illustration of a “risk premium” without a commensurate measure of the risk. Although the ACLI and its constituent companies have repeatedly argued in favor of showing a risk premium in the illustrated scale, they have omitted a mathematical measure of the risk that creates the reward. Fortunately, calculating the risk within the strict confines of the maximum AG 49 illustrated rate is relatively easy.

The illustrated risk premium for Indexed UL is a function of the hypothetical historical lookback methodology (HHLM) detailed in Section 4 (A) of AG 49. This calculation is entirely arbitrary in that it defines a 66 year lookback period, prescribes 25-year rolling geometric averages and uses the arithmetic average of all of the observations as the maximum illustrated rate for the product. Currently, for example, a 10% Cap BIA would result in a 6.2% illustrated rate. Had the parameters been altered to different start dates and different segment lengths (50-10 years), the maximum illustrated rate could have ranged from a low of 5.83% to a high of 7.49%. Most importantly, the calculation uses the *average* of all of the 25-year segments. The lookback methodology prescribed in AG 49, in effect, dictates that the illustration should show the risk premium associated with a 50% failure rate based on the assumption of constant caps and future index performance mirroring past index performance.

To put this in stark terms, imagine the following example: A client purchases an Indexed UL product and plans to fund the product with a minimum premium to maintain coverage for life. Running the illustration at the maximum AG 49 illustrated rate produces an illustrated level premium of, say, $10,000 annually. What is the likelihood that the $10,000 will maintain coverage through maturity? Roughly 54%, using the actual historical data driving the HHLM in AG 49. Graphically, here is the outcome of returns for this scenario based on the hypothetical historical data feeding the maximum illustrated rate in the current AG 49 calculation for a 10% Cap BIA.
However, even this overstates the true likelihood of success because it rests on the assumptions that the index parameters will not change, that future equity performance will mirror past equity performance and does not show the impact of return volatility. Each of these assumptions are false or wildly aggressive. Future equity returns are <em>broadly expected</em> to be less than 7% and nowhere near the historical average of 11% for the S&P 500 Total Return. Indexed credits are vary in the real world and cause sequence of return risk. But most importantly, caps have fallen consistently since 2015 as a result of falling general account yields and adverse option pricing. For example, the ACLI spreadsheet assumes the price of a 10% cap to be 4.31% based on 2015-2019 data and the Black-Scholes formula. Today, an option budget of 4.31% would purchase an 8.5% cap. Below is the same graph as above but recalibrated with today’s fair-market cap of 8.5% as opposed to the 10% cap shown in the first graph.

Note that while the Independent Proposal would produce roughly the same illustrated rate for both caps because of the rising price of the options, the hypothetical historical lookback proposal currently used in AG 49 and preserved by the ACLI proposal would produce wildly different illustrated rates, highlighting the real-world instability of the HHLM and misleading clients as to performance expectations.

Despite the fact that the baseline failure expectation of an illustration using the maximum AG 49 illustrated rate is nearly 50%, none of this risk is disclosed to clients. They see a risk premium, but no risk. It is little wonder, then, why Indexed UL has become the fastest growing part of the life insurance industry and now commands over a 3rd of new permanent life insurance premiums. It is also little wonder why multipliers and buy-up caps, which simply increase the risk and the potential reward of the strategy, have come to dominate the market. If the only thing clients are seeing is reward without any measure of risk, why would they choose anything different?

And, finally, it is little wonder why the ACLI and its constituents are clinging to this flawed methodology. Illustrations sell. Illustrations that show reward with no risk sell even better. What will happen to the Indexed UL sales if the product can no longer illustrate reward without risk? This is not an academic question, but a practical and essential one for life insurers selling Indexed UL. Of the top 20 Indexed UL writers, Indexed UL makes up the majority of sales for 16. More than half of Indexed UL premium is written at life insurers where Indexed UL makes up more than 80% of sales. Much is at stake. But as one regulator noted on a previous call, informed clients would not change their decision based on illustrated performance. In my experience working with countless retail clients, I completely agree with this sentiment. Informed clients see illustrations for their Type A usage, not for improper Type B projections. If life insurance companies have the same view, then why would they be so resistant to replacing a flawed methodology that has now resulted in two regulatory actions to rein in real or perceived abuses stemming from overly aggressive illustrations with something more reflective of fair-market values?
The Independent Proposal Provides the Only Permanent Solution

Remedying this disconnect between illustrated reward and non-illustrated risk is the only way to satisfy the goals stated by regulators. Both the ACLI proposal and Independent Proposal recommend eliminating the impact of the illustration of reward without risk. The ACLI proposal attempts to achieve the goals of the regulators by specifically eliminating the illustration of reward without risk for index-linked features, including multipliers and buy-up caps, that are funded with option budget in excess of the NIER. But in doing so, the ACLI proposal substantially modifies the original guideline in both its letter and spirit, introduces new and ambiguous definitions and formulas and allows non-disclosed elements to affect illustrated performance, rendering illustrations less understandable for consumers. We have detailed the problems with the ACLI proposal in previous letters. The long-run side effects of the strategy proposed by the ACLI proposal may prove to be worse than its benefits.

The Independent Proposal, by contrast, eliminates the illustration of reward without risk for all index-linked credits regardless of how they are funded. It is simple, effective and comprehensive. It meets all of the goals stated by the regulators regarding multipliers and buy-up caps. It does not “renegotiate” AG 49 – it requires just one simple change to Section 4, which is a modular section that can be swapped out without any impact to the rest of the guideline. It does not change the 145% factor in Section 5. Furthermore, the rates shown by the Independent Proposal would accurately reflect the level of the current index parameter, allowing for clear differentiation between the rates shown by different companies or in different accounts.

The only side effect of the Independent Proposal is that it produces more realistic and robust illustrations for consumers that will set expectations such that policies are funded to have a high likelihood of success over the long run. This is the basic concept behind all other fixed life insurance illustrations, where the likelihood of success is 100% assuming no changes to the non-guaranteed elements. The equivalent likelihood of success for an Indexed UL product assuming no changes to non-guaranteed elements and illustrating at the maximum AG 49 rate is 56%. It would be a bizarre argument for one to make the case that, somehow, clients are better served with illustrations that have lower illustrated premiums or higher illustrated distributions but a very high likelihood of failure. If regulators did not choose this illustration regime for other fixed products, then why Indexed UL?

However, the Independent Proposal recognizes that Indexed UL has the real possibility of outperformance as well as underperformance, particularly over short periods of time. Understanding the variability of returns and the potential for both upside and downside is absolutely essential for consumers to make an informed decision. As a result, the Independent Proposal provides for augmented supplemental crediting reports that show a range of variable returns, including those with a clear risk premium. This same methodology has been used in Fixed Index Annuity illustrations with broad support from life insurers. As in FIA, this methodology used in the supplemental crediting reports described in Section 7 of AG 49 would enhance the understanding of consumers, allow life insurers to differentiate their products and promote the potential benefits (and risks) of the index-linked crediting strategy. All of the marketing and promotion done by life insurers about the merits of their crediting strategies, including multipliers and buy-up caps, could be fully demonstrated in these reports. Life insurers would not be constrained in any way to both innovate their crediting strategies and position them with clients.

As a result, I urge the Subgroup to adopt the Independent Proposal. The ACLI and other life insurers who have spoken with their own voice, such as Equitable, can further enhance the proposal On behalf of my co-signers, I would welcome their input and input from regulators.

Bobby Samuelson
Executive Editor
The Life Product Review