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May 10, 2019

NAIC Annuity Disclosure (A) Working Group, the Honorable Mike Yanacheak, Chair
c/o Jennifer R. Cook, Senior Health Policy Advisor and Counsel
National Association of Insurance Commissioners (NAIC)
Executive Office, Hall of the States Building, Suite 700
444 North Capitol Street, NW
Washington, D.C. 20001-1512

RE: Response to Request for Comment: *Annuity Disclosure Model Regulation (MDL 245), 3-7-19 Exposure Draft*

Dear Chairman Yanacheak and Members of the NAIC Annuity Disclosure Working Group:

NAFA, the National Association for Fixed Annuities,[1] is pleased to submit this letter in response to the NAIC Annuity Disclosure (A) Working Group's request for comments regarding its proposed revisions to the NAIC Annuity Disclosure Model Regulation #245 (the "Model Regulation"), dated March 7, 2019 (the "Exposure Draft").[2] In particular, we will comment generally on the proposed change included in Section 6 of the Exposure Draft to double – from 10 years to 20 – the time indices must have been in existence in order to be used in annuity illustrations and will comment more specifically on our concerns regarding some of the proposed language in the Exposure Draft, including the following:

- Requiring the index to be comprised of "a combination of indices" rather than being comprised entirely of components is problematic and unduly restrictive

[1] NAFA, the National Association for Fixed Annuities, is the premier trade association exclusively dedicated to fixed annuities. Our mission is to promote the awareness and understanding of fixed annuities. We educate annuity salespeople, regulators, legislators, journalists, and industry personnel about the value of fixed annuities and their benefits to consumers. NAFA's membership represents every aspect of the fixed annuity distribution and marketplace for fixed annuities sold by independent agents, advisors and brokers. NAFA was founded in 1998. For more information, visit www.nafa.com.
[2] https://www.naic.org/documents/cmte_a_adwg_exposure_draft_249_index_rev.pdf?31

- Requiring the algorithm to "be fixed from the creation of the index" would hobble index sponsors' ability to make necessary modifications to the index in response to significant market events
- Requiring the algorithm be made available to the consumer would expose proprietary information unhelpful for consumers in understanding how the index works
- New disclosure requirements should be refined to reflect the independent relationship between an index sponsor and the issuing insurer, which makes it difficult for insurers to warrant the accuracy of index disclosures, and to limit the ability of consumers to request continued clarification on index algorithms

The increase to 20 years would eliminate the vast majority of indexes currently being used to illustrate fixed indexed annuities, severely restricting consumer choice and creating an unfair advantage within the financial and retirement services industry

NAFA understands, in principle, the Working Group's interest in increasing the number of years of required data so that a longer historical record of the general economy may be captured for use in illustrating a hypothetical record of return, but we believe expanding that time period to 20 years would exclude many indices currently available and being used in illustrating annuity products, which would, of course, result in limiting consumer choice.

The reason most of the indexes have not been in existence for 20 years is because financial markets have changed significantly in the last two decades; only recently, we have witnessed a proliferation of data and new financial indexes and instruments being available. Moreover, there has been a large shift to passive investing, which has effectively lowered investor cost. These same passive investments are key building blocks in volatility control indexes, and many of these have not existed for 20 years. The addition of volatility control mechanisms within indexed interest strategies is a very significant and beneficial development in the entire annuity industry, for both fixed indexed and variable annuities. The benefits of volatility control were known – but were rather academic and arcane prior to the Great Recession of 2008 and 2009. The investment and annuity worlds added volatility control mechanisms to manage various risks inherent to offering annuities or owning annuities.

Volatility control reduces risk, so indexed annuity carriers can offer more interest potential to annuity buyers and, in turn, annuity buyers have the potential to earn more interest. The variable annuity industry uses volatility control or volatility management features to hedge their risk in offering guaranteed lifetime income benefits. With better risk management, carriers can offer more competitive features and benefits to their annuity clients. Volatility control and management features are easy to find in the mutual fund industry, with exchange-traded funds, within structured investment products, and even indexed bank certificates of deposit. If the addition of a volatility control mechanism to an otherwise available index would make that index a "new" index requiring twenty years' worth of history, the financial services world will be taking a very large step backwards.

And, while expanding the current 10-year threshold to twenty years would allow for the inclusion of the financial crisis (and subsequent recovery) of 2008/2009, we would note that under a fixed indexed annuity structure, there is less value in extending the time requirement to include the financial crisis due to fixed indexed annuity's zero percent floor and the cap applied to the interest credit, versus using the raw index return. Moreover, if, under a revised Model Regulation, indexed annuity interest strategies cannot be illustrated because they lack enough history, substantial consumer interest will migrate to the investment industry. Such a trend would bring less principal protection, less guaranteed income, and higher costs. Twenty years of index performance history might be relevant for an investment product, where client principal is at risk of substantial market loss. For fixed indexed annuities, however, ten years of market history permits greater illustration of more choices, making many more products available for consumer evaluation and comparison.

An annuity illustration that meets today's regulatory requirements is a very robust and meaningful disclosure document. It explains much about the workings of the annuity products – and its limitations. It illustrates three different scenarios, so that some reasonable and credible view is gained of the annuity's potential performance. A twenty-year history requirement would prevent the illustration of annuities with innovative and proprietary indexed interest strategies. However, while the use of illustrations of less than 20 years would be prohibited, it would not prevent the *sale* of annuities with these types of indices and underlying interest strategies. We believe that potential annuity purchasers are so much better informed by an illustration today than they would be without any illustration.

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Lastly, severely limiting the illustration of interest strategies by imposing a 20-year requirement risks creating something like an oligopoly or monopoly in the index licensing industry. S&P Dow Jones remains the dominant index licensing firm in the indexed annuity industry – but, twenty years ago, S&P Dow Jones was almost the only index licensing firm available to insurance carriers offering indexed annuities. Licensing costs are higher when the provider is the dominant licensing provider. A 20-year threshold requirement will reduce consumer choice and increase consumer cost, and it will stifle innovation.

Section 6.F(9)(b)(i) – Requiring the index to be a "combination of indices, each of which has been in existence for at least twenty (20) years" is problematic and unduly restrictive

The language change from the Working Group's earlier exposure draft from requiring an index to be comprised entirely of "components" to the requirement in the current Exposure Draft to be "a combination of indices" is significant and problematic. An index may be comprised of other indices, but they often also include other non-index financial instruments, such as stocks, futures contracts, and exchange-traded funds (ETFs). Requiring the index to be a combination of indices would exclude these common index components, narrowing the definition of index unnecessarily and without any demonstrable consumer protection benefit.

Accordingly, NAFA would urge the Working Group to revise Section 6.F.9(b)(i) to read, **"The index is a combination of underlying index components, each of which has been in existence for at least [the requisite number of] calendar years."**

In addition to this change, we believe further definition or explanation of underlying index "components" is needed to explain how to get to the requisite number of years of existence to satisfy this requirement. While we would prefer this be formally defined in the Definitions section of the Model Regulation, we also recognize that it may be difficult to encourage the Working Group to go beyond its current (A) Committee charge and open up other sections of the Model Regulation. As such, we believe it would be best to try to explain through a Drafting Note what is meant by the start date for an underlying index component so that regulators are not faced with interpreting a component start date in such a way that may be inconsistent or harmful – and which might have the consequence of creating an unlevel playing field.

The Drafting Note should provide clarity for determining whether an index component has been "in existence" for the requisite time period. In looking at the many index components utilized today, as well as the consumer benefits resulting from index innovation, we believe the index component start date should be able to be determined in one of two ways, depending on the type of underlying index component:

(1) In cases where the underlying index component has a clear, published live date (not reliant on hypothetical data), the start date would be the published live date.

(2) In cases where the underlying index component is comprised solely of other underlying components, the index component start date would be the date upon which each of the underlying components, standing on its own, has been in existence for the requisite number of calendar years and which also has a published live date of its own.

In summary of the above, NAFA proposes the following Drafting Note to Section 6.F(b):

> **Drafting Note: An underlying index component is considered in existence for at least [the requisite number of calendar years], so long as (1) it has a published live date exceeding at least [the requisite number of] calendar years or (2), where the index component is comprised entirely of other underlying components, each of those components have a published live date exceeding at least [the requisite number of] calendar years.**

Section 6.F(9)(b)(iii) – Requiring the algorithm to "be fixed from the creation of the index" would limit the flexibility of index sponsors to ensure the integrity of the index in the event of significant economic market changes.

NAFA is, in general, supportive of the spirit of the language here to require any algorithm or other method of combining the indices to be fixed from the creation of the index, but we want to make sure that there are not unintended consequences. A literal interpretation of the proposed amendment may prevent index sponsors from modifying algorithms or other methods of combining Reference Index components when modification becomes necessary in response to actions beyond the control of the index sponsor. Examples of index sponsors being required to act include, admission of a new company into the S&P 500 or when dealing with a replacement for LIBOR because the benchmark is no longer available.

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Most index sponsors have rule based governance structures in place that allow for the modification of the index when such a modification if necessary in response to a significant change to ensure continuation of the index. NAFA recommends that the Working Group provide an exception to the proposed requirement that would allow index sponsors to modify algorithms or other methods of combination in response to significant events as permitted by the index sponsor's written governance policies. An exception will preserve flexibility for index sponsors to modify algorithms and other methods of combination in response to significant events.

Section 6.F(9)(b)(iv) – Requiring the algorithm or other method supporting such an index included in the illustration be made available to the consumer would expose proprietary information unhelpful for consumers in understanding how the index works.

The language here suggests that an actual rule book for the algorithm or method is available and readily sharable to consumers. Algorithms are often proprietary – and there are good reasons for this. While NAFA could support a requirement to share information with an insurance commissioner, we do not think it helpful or necessary for the consumer to have such information. For consumers, we believe it is important that materials are available that adequately explain the index algorithm. Index providers, in fact, currently create materials that explain how the index works in plain language – something that is helpful for greater consumer understanding – without providing certain unnecessary, and often proprietary, details that are included in the official rule book.

Section 6.G.(4)(b) – The language regarding disclosure should be amended so insurers are not held accountable for disclosing non-substantive changes to indices, and consumers should be limited in their ability to request continued clarification on algorithms.

NAFA generally supports the concept and principles for using disclosures under the Exposure Draft, but the new amendments could be confusing and problematic for insurers trying to determine the accuracy of such disclosures. Index sponsors that operate indices are generally independent of the issuing insurer, and it would be difficult for the insurer to confirm the accuracy of the index disclosures. NAFA recommends that the model indicate that these disclosures will not result in insurer responsibility if the insurer receives annual certifications affirming the accuracy of the disclosure from the index sponsor.

NAFA also recommends that Working Group consider deleting or limiting the language in Section 6.G.(4)(b)(i)(IV) and (ii)(II), allowing consumers to request further explanation of algorithms used to determine the weights used in combining the indices, because it would likely cause additional consumer confusion and could create a potential endless loop of follow up between consumers and index sponsors trying to provide additional information that further explains the algorithm. Algorithms are extremely complicated processes, and in most cases no amount of further explanation will add value or assist a consumer decide whether or not to purchase an annuity.

Conclusion

On behalf of NAFA's members, again, thank you for opportunity to submit these comments. Please do not hesitate to contact me if you would require any additional information.

Sincerely,

Charles DiVencenzo
NAFA President and CEO

NAFA
NATIONAL ASSOCIATION FOR FIXED ANNUITIES
Educate. Advocate. Integrate.