ACLI COMMENTS

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ACLI and CAI Comment Letter to ALVA Subgroup

May 2, 2022

Mr. Peter Weber, Chair
Mr. Tomasz Serbinowski, Vice Chair
National Association of Insurance Commissioners
LATF Index-Linked Variable Annuity (ILVA) (A) Subgroup

RE: ILVA Subgroup Exposure of *Actuarial Guideline ILVA: Nonforfeiture Requirements for Index Linked Variable Annuity Products Supported by Non-Unitized Accounts*

Dear Messrs. Weber and Serbinowski:

The American Council of Life Insurers (ACLI)[1] and the Committee of Annuity Insurers (CAI)[2] appreciate the opportunity to submit comments to the ILVA Subgroup on the Chair's exposure of *Actuarial Guideline ILVA: Nonforfeiture Requirements for Index Linked Variable Annuity Products Supported by Non-Unitized Accounts* (Exposure).

As you know, we provided extensive comments on the Subgroup's original exposure of a proposed ILVA Actuarial Guideline (AG). Our comments stemmed from several key realities, particularly that registered index-linked annuity (RILA) or ILVA products are fundamentally spread-based products and that insurers employ a variety of practices with respect to where assets supporting these products are maintained. For these and other reasons, we noted the inherent challenges associated with developing an AG based on the definition of variable annuity in in the NAIC's *Variable Annuity Model Regulation* (Model 250), and we emphasized that critical changes needed to be made to the original exposure in order to make it workable.

Therefore, we are gratified that the Exposure takes a different approach and specifies conditions for exemption as a variable annuity from the NAIC's *Standard Nonforfeiture Law for Individual Deferred Annuities* (Model 805) and that it does not attempt to modify or interpret the definition of a variable annuity under Model 250. We believe issuing an AG with principles and requirements for determining interim values such that a RILA is considered a variable annuity and therefore exempt from Model 805 makes sense.

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[1] The American Council of Life Insurers (ACLI) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States.

[2] The Committee of Annuity Insurers is a coalition of life insurance companies that issue annuities. It was formed in 1981 to address legislative and regulatory issues relevant to the annuity industry and to participate in the development of public policy with respect to securities, state regulatory and tax issues affecting annuities. The CAI's current 30 member companies represent approximately 80% of the annuity business in the United States.

However, as we emphasized in our earlier comments, for an AG to be workable, it is critical that the interim value framework set forth therein both be consistent with the core design principles used to create RILAs and that it takes into account market realities. While the Exposure is more principles based, and in that regard, less restrictive than the original exposure, there are aspects of it that continue to be too restrictive and therefore would not meet some of the Subgroup's own objectives, including encompassing products currently in the market and fostering product innovation.

Accordingly, the ACLI and the CAI urge the Subgroup to make certain modifications to the Exposure. These revisions are necessary so that the AG appropriately addresses important risk management requirements and aligns with the flexibility needed related to market valuation and trading dynamics. Our recommended revisions are reflected in the attached mark-up of the Exposure. In addition to addressing the points just noted, our revisions shown in the attached mark-up provide suggested guidance for how to apply the concept of "materially consistent" and clarify the applicability of Section 7 of Model 250 to RILAs.

More particularly, our principal revisions are found in the following provisions:

Principles:

We have added language to the second principle to ensure the value of derivative assets will be based on assumptions that are consistent with market valuation dynamics. In addition, a fourth principle has been added to clarify that market value adjustments can be applied at a contractual or interim value level to reflect changes in the market values of fixed income assets. This is necessary because ILVAs are fundamentally spread based products with asset liability matching risks such as disintermediation that insurers need to mitigate.

Fixed Income Asset Proxy:

Our revisions broaden the definition so that it: (a) allows for various amortization approaches that can be aligned with the underlying asset market values; (b) accommodates market value adjustments referenced under the principles; and (c) specifies discounting techniques that will be described in the actuarial certification. We believe this aligns with a market-based valuation.

Derivative Asset Proxy:

Our revisions replace the prescribed unwind cost of "10 bps" with a provision for reasonable costs to align with marketplace trading conditions, as the unwind cost can be significant in volatile markets particularly for complex payoff structures. Our revisions further introduce a broadened definition to allow for more tailored, risk-sensitive unwind risk provisions that will be described in the actuarial certification.

An example of acceptable "materially consistent" demonstration:

In the Drafting Note of our mark-up, we provide an example of how to demonstrate materially consistent based on average results over a stochastic scenario set that is within 5% of the results produced using the Hypothetical Portfolio. Our mark-up recognizes that companies may choose whether to use stochastic or deterministic approaches that will be described in the actuarial certification.

ILVA nonforfeiture benefit compliance with Section 7 of Model 250:

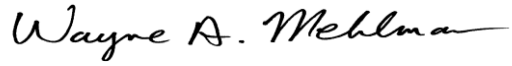
So as to avoid any unintended confusions, we have added language clarifying that complying with Section 7.B. of Model 250 is not required, and that market value adjustments are included in net investment return for purposes of demonstrating Section 7 compliance.

We would also note that the net investment return used to demonstrate Section 7 compliance should be net of asset-based charges and therefore would include any explicit fees as well as any market value adjustments. Therefore, the 7% in Model 250 would be grossed up for variable annuity asset-based charges and then reduced for the aforementioned items or utilize average returns by index and then reduce for the aforementioned items.

The ACLI and the CAI appreciate the opportunity to comment on the Exposure and we urge continued discussion and collaboration to develop an AG that satisfies our shared objective - and well stated principle - of equity to both contract holders and insurers in the design and administration of RILA products. Further, the ACLI and CAI appreciate the NAIC's stated desire to minimize any market disruption that could occur as a result of this AG. In that spirit, we are hopeful that the NAIC will continue to work with the ACLI and CAI on transition timing that appropriately reflects the practical realities of implementation as the AG is finalized.

Respectfully submitted,

AMERICAN COUNCIL OF LIFE INSURERS (ACLI)



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Proposed Actuarial Guideline on ILVAs
from the
American Council of Life Insurers (ACLI) and Committee of Annuity Insurers (CAI)
(May 2, 2022)

Actuarial Guideline ILVA
Nonforfeiture Requirements for Index Linked
Variable Annuity Products Supported by
Non-Unitized Accounts

Background

The purpose of this guideline is to specify the conditions under which an Index-Linked Variable Annuity (ILVA) is consistent with the definition of a variable annuity and exempt from Model 805 and specify nonforfeiture requirements consistent with variable annuities.

A number of insurers have developed and are issuing annuity products with credits based on the performance of an index with caps on returns, participation rates, spreads or margins, or other crediting elements, which include limitations on loss such as a floor or a buffer. These products are not unitized and do not invest directly in the assets whose performance forms the basis for the credits. However, unlike traditional non-variable indexed annuities, these annuities may reflect negative index returns.

There is no established terminology for these annuity products. These products go by several names, including structured annuities, registered index-linked annuities (RILA), or index-linked variable annuities, among others. This guideline refers to these products as index-linked variable annuities (ILVA).

Variable annuities are exempted from the scope of NAIC Model 805, *Standard Nonforfeiture Law for Individual Deferred Annuities,* however, NAIC Model 805 does not define the term "variable annuity".

NAIC Model 250, *Variable Annuity Model Regulation*, defines variable annuities as "contracts that provide for annuity benefits that vary according to the investment experience of a separate account" Section 7B of NAIC Model 250 provides that "to the extent that a variable annuity contract provides benefits that do not vary in accordance with the investment performance of a separate account" the contract shall satisfy the requirements of the NAIC Model 805.

The application of the NAIC Model 250 to a traditional variable annuity with unitized values is straightforward. The unitized feature provides an automatic linkage between annuity values and the investment experience of a separate account. Daily values (market values of the separate account assets) are the basis of all the benefits, including surrender values.

The fact that ILVA products are not unitized means they do not have values determined directly by the market prices of the underlying assets. Therefore, this guideline sets forth

ACLI and CAI Proposed AG on ILVAs
(Redline)

principles and requirements for determining values, including death benefit, withdrawal amount, annuitization amount or surrender values, such that an ILVA is considered a variable annuity and thereby exempt from Model 805. An ILVA that does not comply with the principles and requirements of this guideline is not considered a variable annuity and therefore is subject to Model 805.

Drafting Note: This guideline interprets the term "variable annuity" for purposes of exemption from Model 805. It is not intended to modify or interpret the definition of a variable annuity under Model 250 or other Model Regulations.

Scope

This guideline applies to any index-linked annuity exempt from the NAIC Model 805 on the basis that it is a variable annuity provided through non-unitized separate account(s) and includes index-linked crediting features that are built into policies or contracts (with or without unitized subaccounts) or added to such by rider, endorsement, or amendment.

This guideline does not apply to an annuity contract or a subaccount of an annuity contract that is subject to the requirements of NAIC Model 805, Standard Nonforfeiture Law for Individual Deferred Annuities.

Principles

This guideline is based on the following principles:

1. There exists a package of derivative assets that replicates the index credits provided by an index strategy at the end of an index term.
2. The value of the package of derivative assets can be determined ~~daily~~ using assumptions consistent with observable market ~~values~~inputs and parameters, whenever possible.
3. Interim Values defined in the contract provide equity to both the contract holder and the company where the Interim Values are consistent with the value of the Hypothetical Portfolio over the index term.
4. Market Value Adjustments that reflect changes in the value of hypothetical fixed income assets due to interest rate and/or credit spread movements are allowed. They may be applied in the Interim Value calculation or at the contract level.

Definitions

"Derivative Asset Proxy" means a package of hypothetical derivative assets designed to replicate credits provided by an Index Strategy at the end of an Index Term.

"Discount Rate" means the rate used to calculate the value of the Fixed Income Asset Proxy during the Index Strategy Term. This rate may be a simple or compound rate, may be expressed as a risk-free rate plus a spread, or may be an implied rate used to amortize the initial Derivative Asset Proxy value over the Index Strategy Term as described in the actuarial certification.

"Fixed Income Asset Proxy" is a hypothetical fixed income asset.

"Hypothetical Portfolio" means a hypothetical portfolio composed of a Fixed Income Asset Proxy and a Derivative Asset Proxy.

"Interim Value" mean the Strategy Value at any time other than the start date and end date of an Index Term.

"Index Strategy" means a method used to determine index credits with specified index-or indices or observable benchmarks and cap, buffer, participation rate, spread, margin or other index crediting elements.

"Index Strategy Base" means the notional amount used to determine index credits that does not change throughout the Index Term except for withdrawals, transfers, deposits, and any explicit charges.

"Index Strategy Term" means the period of time from the term start date to the term end date over which an index change and index credit is determined. A term may end due to product and/or crediting features (e.g., a specified end date, a "lock-in" feature, etc.)

"Strategy Value" means the value, attributable to an Index Strategy, used in determining values including death benefit, withdrawal amount, annuitization amount or surrender values.

Text

Index Strategy Base must equal the Strategy Value at an Index Term start date.

The value of the Fixed-Income Asset Proxy:

a. At the beginning of the Index Strategy Term equals the Index Strategy Base less the Derivative Asset Proxy value; and
b. At any point in time between the Index Strategy Term start date and the end of the Index Strategy Term, is determined by discounting the Index Strategy Base for the remainder of the Index Strategy Term at the Discount Rate. This may also be subject to a Market Value Adjustment as outlined in Principle 4; and
~~b.~~c. At the end of the Index Strategy Term equals the Index Strategy Base~~; and~~.
~~a. Earns interest at a level rate.~~

The value of the Hypothetical Portfolio at any time is the sum of the Fixed-Income Asset Proxy value and the Derivative Asset Proxy value less a provision ~~for the cost of unwinding the hedge positions not to exceed 10 bps.~~designed to address the reasonable cost of unwinding the Derivative Asset Proxy. Such a provision may be either applied to all circumstances or take the form of a more targeted adjustment applicable only in specific circumstances in which the risk of unwinding Derivative Asset Proxy may be heightened as described in the actuarial certification.

Contracts in the scope of this guideline must provide Interim Values that are consistent with the value of the Hypothetical Portfolio over the ~~index term~~Index Strategy Term.

If a contract provides Interim Values determined using a methodology other than a Hypothetical Portfolio methodology as described in this guideline, the company must demonstrate that the contractually defined Interim Values will be materially consistent with the Interim Values that would be produced using the Hypothetical Portfolio methodology for each combination of Index Strategy and Index Strategy Term. The company may choose to demonstrate under a reasonable number of ~~economic~~stochastic economic scenarios or a set of deterministic scenarios.

Drafting Note: ~~Acceptable~~ One example of an acceptable demonstration of materially consistent would show that at intermediate points during the Index Strategy Term, the expected value of Interim Values produced using the Hypothetical Portfolio minus the expected value of contractually defined Interim Values is at most 5% of the Index Strategy Base. The expected value will be defined as the average of the Interim Values over the set of economic scenarios ~~over which consistency should to be demonstrated is yet to~~. Acceptable stochastic economic scenarios may be ~~determined. Considerations are~~from the Academy Interest Rate Generator ~~and/~~or ~~defined~~ any other reasonable real-world economic scenario generator where the generator and any key additional assumptions used to value the Derivative Asset Proxy are described in the actuarial certification. If deterministic scenarios are used, these may include shocks that trigger Index Strategy parameters including but not limited to caps, floors, and buffers.

~~The~~At the time of filing, the company must provide an actuary's certification that the provisions of this guideline are being met.

Assumptions used to value the Derivative Asset Proxy including yields, implied volatility, risk-free rate, ~~and~~ dividend yield, and other parameters required for the valuation method of the derivatives must be consistent with the observable market prices of derivative assets, whenever possible.

ILVA nonforfeiture benefits must comply with Section 7 of Model 250 (other than Section 7.B) with net investment return (reflecting any Market Value Adjustment and any explicit fees) consistent with the requirements for determining Interim Values in this guideline.

The company (or actuary) must describe the Fixed Income Asset Proxy and the Derivative Asset Proxy ~~and~~with the assumptions used to calculate ~~its value~~these values at any time~~.~~ (including the reasonable cost of unwinding the Derivative Asset Proxy).

Effective Date

ACLI and CAI Proposed AG on ILVAs
(Clean)

Proposed Actuarial Guideline on ILVAs
from the
American Council of Life Insurers (ACLI) and Committee of Annuity Insurers (CAI)
(May 2, 2022)

Actuarial Guideline ILVA
Nonforfeiture Requirements for Index Linked
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Background

The purpose of this guideline is to specify the conditions under which an Index-Linked Variable Annuity (ILVA) is consistent with the definition of a variable annuity and exempt from Model 805 and specify nonforfeiture requirements consistent with variable annuities.

A number of insurers have developed and are issuing annuity products with credits based on the performance of an index with caps on returns, participation rates, spreads or margins, or other crediting elements, which include limitations on loss such as a floor or a buffer. These products are not unitized and do not invest directly in the assets whose performance forms the basis for the credits. However, unlike traditional non-variable indexed annuities, these annuities may reflect negative index returns.

There is no established terminology for these annuity products. These products go by several names, including structured annuities, registered index-linked annuities (RILA), or index-linked variable annuities, among others. This guideline refers to these products as index-linked variable annuities (ILVA).

Variable annuities are exempted from the scope of NAIC Model 805, *Standard Nonforfeiture Law for Individual Deferred Annuities*, however, NAIC Model 805 does not define the term "variable annuity".

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The application of the NAIC Model 250 to a traditional variable annuity with unitized values is straightforward. The unitized feature provides an automatic linkage between annuity values and the investment experience of a separate account. Daily values (market values of the separate account assets) are the basis of all the benefits, including surrender values.

The fact that ILVA products are not unitized means they do not have values determined directly by the market prices of the underlying assets. Therefore, this guideline sets forth

principles and requirements for determining values, including death benefit, withdrawal amount, annuitization amount or surrender values, such that an ILVA is considered a variable annuity and thereby exempt from Model 805. An ILVA that does not comply with the principles and requirements of this guideline is not considered a variable annuity and therefore is subject to Model 805.

Drafting Note: This guideline interprets the term "variable annuity" for purposes of exemption from Model 805. It is not intended to modify or interpret the definition of a variable annuity under Model 250 or other Model Regulations.

Scope

This guideline applies to any index-linked annuity exempt from the NAIC Model 805 on the basis that it is a variable annuity provided through non-unitized separate account(s) and includes index-linked crediting features that are built into policies or contracts (with or without unitized subaccounts) or added to such by rider, endorsement, or amendment.

This guideline does not apply to an annuity contract or a subaccount of an annuity contract that is subject to the requirements of NAIC Model 805, Standard Nonforfeiture Law for Individual Deferred Annuities.

Principles

This guideline is based on the following principles:

1. There exists a package of derivative assets that replicates the index credits provided by an index strategy at the end of an index term.
2. The value of the package of derivative assets can be determined using assumptions consistent with observable market inputs and parameters, whenever possible.
3. Interim Values defined in the contract provide equity to both the contract holder and the company where the Interim Values are consistent with the value of the Hypothetical Portfolio over the index term.
4. Market Value Adjustments that reflect changes in the value of hypothetical fixed income assets due to interest rate and/or credit spread movements are allowed. They may be applied in the Interim Value calculation or at the contract level.

Definitions

"Derivative Asset Proxy" means a package of hypothetical derivative assets designed to replicate credits provided by an Index Strategy at the end of an Index Term.

"Discount Rate" means the rate used to calculate the value of the Fixed Income Asset Proxy during the Index Strategy Term. This rate may be a simple or compound rate, may be expressed as a risk-free rate plus a spread or may be an implied rate used to amortize the initial Derivative Asset Proxy value over the Index Strategy Term as described in the actuarial certification.

"Fixed Income Asset Proxy" is a hypothetical fixed income asset.

"Hypothetical Portfolio" means a hypothetical portfolio composed of a Fixed Income Asset Proxy and a Derivative Asset Proxy.

"Interim Value" mean the Strategy Value at any time other than the start date and end date of an Index Term.

"Index Strategy" means a method used to determine index credits with specified index-or indices or observable benchmarks and cap, buffer, participation rate, spread, margin or other index crediting elements.

"Index Strategy Base" means the notional amount used to determine index credits that does not change throughout the Index Term except for withdrawals, transfers, deposits, and any explicit charges.

"Index Strategy Term" means the period of time from the term start date to the term end date over which an index change and index credit is determined. A term may end due to product and/or crediting features (e.g., a specified end date, a "lock-in" feature, etc.)

"Strategy Value" means the value, attributable to an Index Strategy, used in determining values including death benefit, withdrawal amount, annuitization amount or surrender values.

Text

Index Strategy Base must equal the Strategy Value at an Index Term start date.

The value of the Fixed Income Asset Proxy:

a. At the beginning of the Index Strategy Term equals the Index Strategy Base less the Derivative Asset Proxy value; and
b. At any point in time between the Index Strategy Term start date and the end of the Index Strategy Term, is determined by discounting the Index Strategy Base for the remainder of the Index Strategy Term at the Discount Rate. This may also be subject to a Market Value Adjustment as outlined in Principle 4; and
c. At the end of the Index Strategy Term equals the Index Strategy Base.

The value of the Hypothetical Portfolio at any time is the sum of the Fixed Income Asset Proxy value and the Derivative Asset Proxy value less a provision designed to address the reasonable cost of unwinding the Derivative Asset Proxy. Such a provision may be either applied to all circumstances or take the form of a more targeted adjustment applicable only in specific circumstances in which the risk of unwinding Derivative Asset Proxy may be heightened as described in the actuarial certification.

Contracts in the scope of this guideline must provide Interim Values that are consistent with the value of the Hypothetical Portfolio over the Index Strategy Term.

If a contract provides Interim Values determined using a methodology other than a Hypothetical Portfolio methodology as described in this guideline, the company must demonstrate that the contractually defined Interim Values will be materially consistent with the Interim Values that would be produced using the Hypothetical Portfolio methodology for each combination of Index Strategy and Index Strategy Term. The company may choose to demonstrate under a reasonable number of stochastic economic scenarios or a set of deterministic scenarios.

Drafting Note: One example of an acceptable demonstration of materially consistent would show that at intermediate points during the Index Strategy Term, the expected value of Interim Values produced using the Hypothetical Portfolio minus the expected value of contractually defined Interim Values is at most 5% of the Index Strategy Base. The expected value will be defined as the average of the Interim Values over the set of economic scenarios. Acceptable stochastic economic scenarios may be from the Academy Interest Rate Generator or any other reasonable real-world economic scenario generator where the generator and any key additional assumptions used to value the Derivative Asset Proxy are described in the actuarial certification. If deterministic scenarios are used, these may include shocks that trigger Index Strategy parameters including but not limited to caps, floors, and buffers.

At the time of filing, the company must provide an actuary's certification that the provisions of this guideline are being met.

Assumptions used to value the Derivative Asset Proxy including yields, implied volatility, risk-free rate, dividend yield, and other parameters required for the valuation method of the derivatives must be consistent with the observable market prices of derivative assets, whenever possible.

ILVA nonforfeiture benefits must comply with Section 7 of Model 250 (other than Section 7.B) with net investment return (reflecting any Market Value Adjustment and any explicit fees) consistent with the requirements for determining Interim Values in this guideline.

The company (or actuary) must describe the Fixed Income Asset Proxy and the Derivative Asset Proxy with the assumptions used to calculate these values at any time (including the reasonable cost of unwinding the Derivative Asset Proxy).

Effective Date