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

RE: Comments on the Exposure of **Actuarial Guideline ILVA - Nonforfeiture Requirements for Index Linked Variable Annuity Products Supported by Non-Unitized Accounts** (PAG2)

Mr. Weber,

As a commenter not employed by a life insurer, or affiliated with a regulatory body, or a trade association, I am very grateful for your consideration of my comments. Having no actuarial training I ask that you please excuse the general nature of my assertions. I would like to present a responsible marketer's perspective. By way of background, as President of CompEdge Financial, I have held a life insurance license since 1982, have supervised Broker/Dealer Branch Office regulated by FINRA, served over 10 years as the President and Chief Compliance Officer of a SEC-registered Registered Investment Adviser firm, and operate an Independent Marketing Organization.

The establishment of a protocol to report interim values within ILVA's is an important task and I appreciate the comments thus far. My concern is that the difficulty in creating the methodology, and the disagreement to date, centers not on what is fair to the buying public but what is easiest and least transparent for the carriers.

While respecting the narrow scope of this subgroup it is important to consider broader contexts to facilitate decision making.

<u>Defined-Outcome Product Background</u>
Hystorically, the objective of a structured investment is to combine non-correlated assets in such a way that they form a defined set of possible outcomes at the date of purchase. Holding various long and short positions in index options is a traditional method of accomplishing this goal. The result is a portfolio designed to exist for a limited period of time in markets where a buy/hold equity strategy presents unacceptable downside risk – an alternative strategy. Often these accounts create a scheme where regardless of market activity the client is not subject to first-dollar losses down to a designed percentage, or a buffer. Typically, private investors and professionals use nearly 100% of the available seed cash in the strategy (minus 1-3% set aside

for expenses and profit). This ensures interim values of the account are easily discernable in real time in the trust or fund based on the market prices of the options employed.

Insurers saw the opportunity to accomplish similar defined outcomes with a slightly different option strategy. Their strategy allows them to create a buffer/cap product while not allocating all the premium to the strategy. In fact, many of the buffer/cap options seen now can be accomplished with no net premium spent on behalf of the client at all.

When done in an annuity chassis, minimal holdings in option positions are held in a separate account while well over 90% of the premium is available for use in the General Account for the carrier's investment in long-term assets, to pay concessions to Broker/Dealers, and provide company profits. This is essentially an interest-free loan of the client's annuity premium to the insurer as collateral should the buffer ever fail, and someone must clean up the mess. There is a cost to this alternative to the investor as it is not possible to achieve the same upside cap available otherwise without the carrier allocating a significant portion of those funds to enhance caps.

**Oversight of Distribution Partners**

Because these products are registered, their distribution falls to Broker/Dealers and their Registered Representatives. B/D's have attempted to insert themselves in the revenue stream of Fixed Indexed Annuity sales for a decade. FINRA requires the B/D to supervise all the RR's recommendations but, as fixed products, the independent RR is free to sell FIAs through any number of other outlets. All attempts to address this have failed. ILVA's give B/D's a successful new revenue stream with all the flavor of an FIA yet registered for distribution only through B/D's.

The SEC Regulation Best Interest (RegBI) details the duties of B/D's and their supervised representatives. RegBI stipulates they must available alternatives to a recommendation, and to consider all relevant costs and limitations. The lack of transparency in the assets held in ILVA's makes fulfilling this duty impossible. It is the only SEC-registered product sold by prospectus that does not detail where every dollar of the client's money goes.

A new term might help identify and compare the true value of each carrier's product. How much money is the carrier allocating to the buffer strategy? A buffer strategy can be accomplished in any brokerage account with no net cost. In other words, the premiums both spent and received on options to produce the strategy can net each other out. This would provide a low upside cap, however. To be competitive carriers must offer higher caps and would have to subsidize the strategy with earnings they would rather bank in the General Account. If we are going to use hypothetical values elsewhere, can we create a concept called the "Option Budget Allocation" expressed as a percentage of the client's premium or annuity value used to enhance caps? My observation has been that this is roughly equal to the percentage the carrier is crediting in the product's fixed account. If so, contract holders are incurring large opportunity costs on their premium while only receiving an economic benefit in the neighborhood of 1%/year on their capital.

Carriers insist ILVA's are spread products and their expenses cannot be quantified. However, they are quick to point out the "spread" concept is not to be confused with the traditional use of the word in an index strategy where the spread percentage is clearly stated. The best of both worlds. Some accountability is needed here.

FINRA is charged with ensuring B/Ds are complying with the SEC's RegBI and have long-standing requirements that RR's avoid misstatements or omissions of material facts. The marketing departments of ILVA providers do not seem to respect the difficulty advisors have in fulfilling these obligations given the materials provided for sales and the talking points of their wholesalers. Let's examine some of those possible omissions and misrepresentations:

1) With few honorable exceptions, carriers claim that they "absorb" all loses from the original principal to the bottom of the buffer. In fact, there is no insurance element to that event whatsoever. Clearly carriers are not risking surplus equal to 10, 15, or 25% of annuity values. There is simply no economic activity as no option is in play in the buffer zone.
2) Sales brochures talk about the upside of the index but fail to prominently mention it is only the price movement of the index being credited and dividends are not included. A fair comparison of outcomes in all markets that included dividends in client brochures would allow more informed decisions.
3) Most insurers offer a 6-year term for each strategy. That is simply too long a term to make any sort of market judgement and the options market reflects that. A 6-year bucket with a 300% cap is virtually uncapped, like an S&P 500 ETF. However, the value of a 10% buffer in an ILVA would be covered by compounded dividends over 6 years in an Index ETF without a buffer. An outright purchase of an S&P 500 ETF will have the same risk characteristics - no ILVA value add.
4) "No Fees" - Many carriers prominently and repeatedly claim to charge no fees in their materials. While there may be no additional out-of-pocket fee this is dangerously misleading. As discussed, the opportunity cost of not investing elsewhere is substantial. If there are no fees, where is the discussion on how the company profits? The implication is that they are free. At the time of sale B/Ds require RRs to complete forms detailing the fees, policy charges, surrender charges, and investment expense percentages on every variable annuity sold. Variable annuities carriers simply must provide that information to protect their distributors. Expenses should be detailed.
5) With no discernable insurance element to a variable tax-deferred product FINRA has held that they are not suitable for funding IRA's or other qualified rollovers since tax-deferral is already present and the underlying investment can be obtained with

lower expenses. Minimal death benefit options and poor living benefit riders may not be enough to overcome this logic.

6) An available alternative to an ILVA is any UIT employing a similar buffer. For any given buffer the caps on UIT's tend to exceed the ILVA. There are notable exceptions. Carriers that do charge a fee to enhance caps or participation rates can outperform with active recommendations by the RR and an astute client.

Interim Value Calculation Debate

Back to the topic at hand which centers on how to calculate interim account values for a contract holder when their contract assets are split between a separate account containing assets with daily pricing and the carrier's general account with no divisible interest or earmarked asset allocated to the contract. I believe the conclusions to be drawn from the terminology created thus far are not helpful[1]. I concur with several of the previous commenters that variable annuity Model 250 should govern, and not by amendments to the Model but rather with amendments to the products. This interim value debate is created by non-adherence to the time-tested traditional structure of variable annuities.

If ILVA's must persist in their current form I would advocate for a simple prorata earnout of the buffer, floor, and cap without regard to Market Value Adjustment's on hypothetical assets or the market price of the underlying hypothetical options. If a withdrawal is needed halfway

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Interim Values Defined

As noted in PAG2, the terminology required to address ILVA features is currently lacking and these efforts to standardize and codify such terminology are admirable. The Proposed Actuarial Guideline 2 defines the Interim Value as follows:

"Interim Value" mean the Strategy Value at any time other than the start date and end date of an Index Term. (Index Term is not defined but I will assume it means the period described as the "Index Strategy Term")

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

If the Interim Value we seek is equal to the Strategy Value on days other than the beginning and ending of an Index Strategy Term then these definitions give us nothing upon which to perform the math.

Later in PAG2, one of the three principles of the guideline states:

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.

Here is the clue that the Interim Values are to be consistent with, presumably equal to, the value of a Hypothetical Portfolio. The Hypothetical Portfolio is also defined as:

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

Therefore, the Strategy Value at times other than the beginning or ending date of the Index Strategy Term is the current Hypothetical Portfolio Value which is the sum of the Derivative Asset Proxy Value, a hypothetical, and the Fixed Income Asset Proxy Value, a value also based on a hypothetical Fixed Income Asset. I understand this language is the result of comments on the previously proposed guideline expressing concerns that using a real asset could produce varying results. Transparency is not the long suit here.

through an index period, a client would expect to receive half the downside protection available, and half the cap purchased. Asking the consumer to be blind to daily values over many years, only to be priced to the market and current interest rates at the time of a needed withdrawal is not equitable.

Solution

I feel ILVA's should be required to strictly adhere to the traditional form of a variable annuity. Such a structure would serve the investing public, create full and fair disclosure of all risks and holdings, and help standardize terms for a basis of competitive comparison, and solve the interim valuation debate. It would also allow for the addition of several other subaccounts to assist in navigating the markets. ILVA's employ short-term alternative strategies as their sole funding option. This is leading to excessive allocations to the product as an accumulation vehicle in a strategy most professionals agree should not exceed 15% of an investor's portfolio.

Include all premiums in the separate account (and relevant subaccounts), only allowing dollars to flow to the carrier's general account according to the well-defined expenses and amounts detailed in the prospectus.

The Interim Value discussion is important but is largely irrelevant until the more glaring fatal flaws are addressed.

Respectfully,

Burt A. Snover, CLU, ChFC President

CompEdge Financial