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NAIC Proposes Actuarial Guidelines for Index-Linked Variable Annuities

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On July 25, 2022, the Index-Linked Variable Annuity (A) Subgroup of the NAIC's Life Insurance and Annuities (A) Committee issued for public comment an exposure draft of proposed actuarial guidelines for index-linked variable annuities (ILVAs).

The guidelines are designed to establish standards for the design and operation of ILVAs so that they more clearly constitute "variable annuities" and, as such, are exempt from NAIC Model 805 - Standard Nonforfeiture Law for Individual Deferred Annuities. Such an exemption is useful because ILVAs generally do not comply with Model 805's requirement that an annuity contract provide for the crediting, at a minimum, of nonforfeiture rates of interest.

The guidelines, therefore, aim to clarify uncertainty about whether ILVAs can be treated as variable annuities for this purpose. That uncertainty arises because, unlike most variable annuities, ILVAs do not entail "unitized" interests in a separate account of the issuing insurance company and do not invest directly in the assets (i.e., the index) whose performance forms the basis for surrender values and other contract benefits.

To bridge this gap, the guidelines set forth in the draft focus on the use and valuation of a hypothetical (or "proxy") portfolio of assets established to fund the issuer's obligations under an ILVA, composed of a fixed income asset proxy and a derivative asset proxy. The fixed income portion of the portfolio covers the issuer's obligation to return principal at the end of a crediting period; the derivative portion (typically consisting of so-called flex options) covers the issuer's obligation to pay interest calculated based on index performance over a crediting period. A basic principle of the guidelines is that, to be treated as a variable annuity under Model 805, an ILVA must provide for interim values (e.g., amounts available for surrender before the end of a crediting period) that are consistent with the market value of the hypothetical portfolio over the crediting period.

Industry commenters on earlier drafts of the guidelines had suggested an alternative method for determining interim values, which contemplated a pro rata application of the relevant index performance over the interim period, subject to a pro rata application of the contractual cap, participation rate, spread, or margin, as well as the floor or buffer, applied pro rata to negative index performance. The draft does not codify this suggested alternative approach but does acknowledge that a contract may provide for a different methodology for determining interim values. The draft provides that, in such a case, the company must demonstrate that the contractually defined interim values will be “materially consistent” over the crediting period with the interim values that would be produced using the hypothetical portfolio methodology.

In general, the guidelines set forth in the draft are more flexible and less prescriptive than the guidelines in earlier drafts. For example, an earlier draft had allowed the valuation of the derivative asset proxy to include a provision for the cost of unwinding the derivative asset positions, which could not exceed 10 basis points (0.10%). Instead, the draft allows a provision “for the cost attributable to reasonably expected or actual Trading Costs at the time the Interim Value is calculated,” recognizing that the costs of unwinding a derivative position over 10 basis points might be appropriate for some issuers in certain (e.g., volatile) market scenarios.

The guidelines set forth in the draft call for an actuarial memorandum to be provided with the ILVA product filing with the state insurance regulator. Among other things, the memorandum would include certifications that:

- The interim values defined in the contract provide “equity” between the contract holder and the insurance company;
- The assumptions used to value the derivative asset proxy are consistent with the observable market prices of derivative assets, whenever possible (using valuation techniques such as the Black-Scholes model, Monte Carlo simulation techniques, etc.);
- Contractually defined interim values are “materially consistent” with interim values that would be produced using the hypothetical portfolio methodology;
- Trading costs assumed in a valuation represent “reasonably expected” or actual costs; and
- Any market value adjustment applicable to the fixed income asset proxy is expected to produce results “reasonably similar” to changes in the market value of the asset.

The draft contemplates that the guidelines will apply to all contracts issued on or after April 1, 2023. Comments on the draft were due by August 23, 2022.

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