CARLTON FIELDS

New Year, New Index-Linked Variable Annuity Actuarial Guideline?

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On November 29, the NAIC Index-Linked Variable Annuity (A) Subgroup (ILVA Subgroup) issued a proposed actuarial guideline to clarify the application of NAIC Model 250, Variable Annuity Model Regulation, and NAIC Model 805, Standard Nonforfeiture Law for Individual Deferred Annuities, to annuity products that periodically credit index-based interest to the annuity value. The index-based interest is based on the performance of one or more indexes or a specified portfolio of assets, and the index-based interest may be negative. Comments on the proposed actuarial guideline are due by January 27, 2022.

The ILVA Subgroup was charged with providing recommendations and changes, as appropriate to nonforfeiture, or interim value requirements related to index-linked variable annuities." To address this charge, the ILVA Subgroup took a fresh look at ILVAs and developed the proposed actuarial guideline, which:

- Would allow an index-linked variable annuity(ILVA) to be viewed as a variable annuity even though ILVA's values are not based on separate account unit values if certain conditions are satisfied. Thus, the ILVA would not need to comply with Model 805's minimum guaranteed interest and minimum guaranteed value requirements.
- Sets forth interim value requirements for an ILVA seeking to be viewed as a variable annuity.

The proposed actuarial guideline recognized that fitting ILVAs into Model 250 is not "straightforward" because ILVAs' daily values are not based on the value of units of a separate account. Rather, the daily values are based on formulas set forth in the ILVAs' contract. Currently, an ILVA's formula:

- At the end of the index option term, looks to the performance of one or more indexes.
- During the index option term, may take into account the time remaining until the end of the index option term, the change in market value of the assets used by the insurer to hedge its obligations to pay the index-based interest, the change in a hypothetical asset pool that replicates the insurer's hedges, and/or the actual change in the index to date, including the full loss to date. While similar types of formulas are used in many ILVAs, there is variation on how interim values are determined among the ILVAs.

The proposed actuarial guideline may be viewed as striking midnight for some interim value formulas as it proposes to allow an ILVA to be considered a variable annuity only if the ILVA's interim value is based on the market value of (i) actual separate account assets or (ii) a hypothetical portfolio of assets, each of which supports the guarantees of the contract. If the interim value is based on a hypothetical portfolio of assets, the proposed actuarial guideline imposes the following additional requirements:

- An actuary must describe the hypothetical portfolio and any difference in value between the hypothetical portfolio and the index option value at the beginning of the index term.
- The hypothetical portfolio must be "designed to perfectly hedge the benefit guarantees at the end of the term."
- The market value of the hypothetical portfolio must be determinable daily.
- The hypothetical portfolio must include a "fixed-income asset proxy" and a "derivative asset proxy." The "fixed-income asset proxy" must represent "a zero-coupon bond that accrues interest, simple or compound, over the index term and matures for a value equal to the initial index option value." The "derivative asset proxy" must represent "a package of hypothetical derivative assets designed to hedge the risks associated with guaranteeing the index option value."

During the December 8 Life Actuarial Task Force meeting, the chair of the ILVA Subgroup explained the rationale behind the proposed interim requirements. The proposed requirements seek to ensure if an ILVA contract holder is being subject to the risk of loss, then the contract holder should also benefit from gains, in the actual separate account assets or hypothetical portfolio assets, as may apply.

If these requirements are adopted, insurers may need to revise their ILVAs to comport with the actuarial guideline's interim value requirements. In addition, a number of questions arise with respect to the additional hypothetical portfolio requirements including:

- What is meant by "designed to perfectly hedge the benefit guarantees"?

- By specifying the “fixed-income asset proxy” and the “derivative asset proxy,” does the proposed actuarial guideline limit an ILVA’s design or how an insurer elects to hedge its obligations owed under an ILVA?
- Can an insurer elect not to hedge some portion of the amount allocated to index options to account for amounts taken from the index option before the end of the index term?

While it may be too early to pop the cork yet,the responsiveness of the ILVA Subgroup suggests that ILVA issuers may yet be able to celebrate in 2022.

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