December 21, 2005

Susan Nash
Associate Director
Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0506

Re: Comments to the Securities and Exchange Commission Concerning Equity-Indexed Annuities

Dear Ms. Nash:

The July 2005 request from the Securities and Exchange Commission (SEC) of insurers that are the major writers of equity-indexed annuities (EIA) suggested to us that the SEC is again interested in considering the issues of what are the characteristics of an EIA and whether an EIA is a security. When the SEC previously addressed these issues with its "Concept Release" in August 1997, the American Academy of Actuaries (Academy) submitted comments. While not solicited by the SEC at this time, the Academy offers these submitted comments as additional background for the current review of EIAs.

We have reviewed and evaluated the characteristics of currently available EIAs, from the perspective of both the purchaser and the insurer. The review includes the risks (or mitigation thereof) of guarantees, the options available to the insurer and purchaser and who controls the assets supporting the EIA contract. We then specifically compare the characteristics of EIAs to fixed-rate annuities and variable annuities (VAs) in order to best illustrate why EIAs are most appropriately regarded as fixed annuities.

EIAs from a Purchaser's Perspective

Contract Characteristics

An EIA that is not registered as a security is a product that is supported by the insurer's general account. Since the Standard Nonforfeiture Law for Individual Deferred Annuities (SNFLIDA) requires general account products to provide a minimum level of guaranteed interest, these EIAs are sold with interest crediting guarantees. This differentiates these EIAs from separate account products, such as a variable annuity, that transfers all or most of the investment risk to the purchaser.

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Current Interest Crediting Guarantee

During each interest-crediting period, whether a single year or a multi-year period, the terms of the EIA interest crediting are guaranteed in advance. The participation rate, cap, or spread fee is determined and declared prior to the start of the period. Although the specific amount of the interest cannot be determined, the terms of the crediting are unalterably set for the remainder of the current interest-crediting period.

Current Interest Floor Guarantee

During each interest crediting period, whether a single year or a multi-year period, a minimum level of credited interest is guaranteed. Commonly, this is a 0% guaranteed interest rate over a one-year period. For multi-year interest crediting approaches, this is commonly expressed as the greater of 0% and a greater guarantee that is derived from compliance with the SNFLIDA.

Minimum Interest Crediting Guarantee in Later Years

Commonly, the changeable factor in the crediting rate formula has a guarantee of the limiting value that will provide a minimum guaranteed benefit when the crediting formula is declared for the second and later interest crediting periods. This is expressed in terms of a minimum cap or participation rate or a maximum spread fee.

Long-term Interest Floor Guarantee

EIAs not intended to be securities (Note-There have been EIAs within a variable annuity and free-standing registered EIAs) have a cumulative guaranteed floor that complies with the SNFLIDA and guarantee positive contract value increases over the holding period of the contract.

Selection of Interest Crediting Basis

The purchaser of an EIA has very limited interest crediting basis choices. A typical contract offers interest crediting based on only one equity index and, possibly, an alternative for fixed-rate crediting. Some contracts may offer a second or third index alternative. In any case, the index is well defined and broadly used in financial markets; consequently, it provides no opportunity for investment direction by the purchaser other than the broad choice of the index.

Limited Reallocation Flexibility

Some EIA contracts offer a single crediting strategy, e.g., participation rate or capped annual crediting, while others provide several choices of strategies, and may also include fixed-rate crediting. With multiple available strategies, the purchaser generally is allowed to reallocate the contract value among strategies at specified times; however, this flexibility generally is limited to times when the underlying hedges would mature. For contracts with annual ratchet designs, this would allow reallocations only on anniversary dates; for multi-year guarantee designs, this would allow reallocations only at the end of the multi-year guarantee periods. Even when reallocations take place between equity-index-based crediting strategies, this generally is simply a change in interest-crediting strategies and not recognition of a different index.

Control of Assets

The underlying assets for a nonregistered EIA are held in the general account of the insurer. This places them beyond the control and direction of the purchaser.

Method of Selling

EIA contracts are sold in a similar fashion as traditional fixed-rate annuities in that the agent selling the annuity is licensed for insurance sales, provides sales literature that has been prepared by the insurer, and applies the same suitability screening that is used for fixed-rate annuity sales.

<u>Comparison with Fixed-Rate and Variable Annuities</u>

The combination of these characteristics can be compared with both a fixed-rate annuity and a variable annuity in order to better understand the significance of the characteristics.

Comparison with a Fixed-Rate annuity

The characteristics of an EIA, as provided to the purchaser, have much in common with those provided by a fixed-rate annuity.

- The current interest-crediting guarantee conveys value in a manner similar to that in a fixed-rate annuity. The call option value of the interest crediting based on participation in the index within an EIA is comparable to the interest that could have been credited if the contract had a fixed-rate structure. This is apparent in EIAs that include a fixed-rate alternative interest crediting strategy, where the insurer provides comparable value in both the index-based interest crediting and the declared-rate crediting.

- The current interest floor guarantee bears similarity to the current interest crediting guarantee in a fixed-rate annuity, although the level of the guarantee may be lower. The lower guarantee provided to the purchaser is compensated for by the potential for higher actual credited interest when the index-based interest outperforms the fixed rate alternative in the contract.

- The minimum interest crediting guarantee in later years is similar to the minimum interest crediting guarantee in fixed-rate annuities. Although the value of the guarantee may vary when the option-pricing value of the guarantee changes to reflect changing interest and index-volatility circumstances, its core value typically maintains consistency with that offered in a fixed-rate annuity.

- The long-term interest floor guarantee is comparable to that in a fixed-rate annuity because both are designed to comply with SNFLIDA. The requirements of SNFLIDA allow a reduction of up to one percent (per year) in the minimum nonforfeiture interest rate for EIAs, but this is in recognition of the additional risk to the insurer due to the dispersion of actual interest crediting results. The lower guarantee allows the potential for more favorable index-based interest crediting that accrues to the benefit of the purchaser.

- Generally, the selection of interest crediting strategies for an EIA provides a single index as a basis for the interest calculation. This is the same degree of selection as in a fixed-rate annuity. Even when a choice of a fixed-rate allocation is available, it is not adding anything beyond what is commonly offered in an annuity. Choices that include several indices provide limited variations insofar as each index is well defined by an external source.

- Differences among index-based interest crediting strategies are primarily a matter of form rather than substance. Differing strategies will still be rooted in the same hedging cost ("hedge budget") and, consequently, are structured to convey the same inherent value. This is very clear when the interest crediting strategies are based upon the same index, but still is basically true even when the index is different.

- Holding of assets supporting the contract in the general account, and thus beyond the control of the purchaser, is identical to the practice on fixed-rate annuities.

- The requirements and oversight (market conduct review) of the sales process are, as for fixed-rate annuities, regulated by the state insurance departments, generally in accordance with NAIC requirements.

Comparison with a Variable Annuity

The characteristics of an EIA, as recognized by the purchaser, can be compared with those of a variable annuity.

- None of the current, floor, future, or cumulative guarantees is present in a variable annuity, insofar as the essence of a variable annuity is the pass-through structure for the investment returns. Even when a variable annuity contains guaranteed living benefits (GLB), e.g., guaranteed minimum income benefit, guaranteed minimum accumulation benefit, guaranteed minimum withdrawal benefit, or a guaranteed payout annuity floor, the interim cash-out value of the variable annuity prior to the maturity of the GLB has no guarantees. In addition, the risk payoff for a VA is not capped.

- The choices in an EIA of allocations among one or a few equity indices and, possibly, one fixed-rate allocation are very limited, in contrast to a variable annuity in which there may be 40 to 60 choices of subaccounts. The content of the EIA choices is currently limited to the construction of the indices, while the variable annuity subaccounts can take on almost any form.

- The holding of the EIA assets in the general account reflects the obligation of the insurer to credit interest on a guaranteed formula basis, whereas the variable annuity assets are held in separate accounts as a reflection of their pass-through nature.

- EIAs are not required to be sold by registered representatives, although many persons selling EIAs are registered representatives. In this regard, sales requirements for EIAs are similar to those for other fixed annuities.

EIAs from an Insurer's Perspective

EIAs can also be characterized on the basis of the way that the insurer manages the product and its risks. This includes the method of investing to support the product and the resulting financial impact on the insurer.

Product Management Characteristics

Assets that Support EIAs

The typical two-fold composition of the assets that support EIAs is first, an index-based hedge that is structured to cover the index-based interest crediting and, second, fixed-yield assets such as bonds for the balance of the required assets. In the most common EIA structure that credits interest annually, this creates a balance of approximately 3-4% of the assets in hedges and 96-97% in fixed-yield investments. Insofar as it is reasonable for an insurer to invest with the same risk profile for both fixed-yield and equity-indexed products, there can be a 96%+similarity in the investments used for EIAs and fixed-yield products.

Asset-Liability Management (ALM)

The insurer takes on the obligation to deliver the guaranteed benefits, and the resultant responsibility of the insurer is to invest appropriately in order to support the guaranteed benefits. The primary result of this is the purchase of hedges to match the index-based interest liability and the purchase of fixed-yield investments to match the other guarantees. Management of the ALM risk to the company requires modeling and tracking the interest and equity risk exposures.

Risk Profile of Insurer

An insurer that has properly invested for an EIA will typically manage the derivative risk either with static hedging (over-the-counter call options or exchange-traded call options) or dynamic hedging (actively-managed combination of derivative instruments, heavily based on index futures). An insurer that has properly hedged the derivative-based risk will have investment income consisting of payoffs on matured hedging instruments and coupons on fixed-yield investments. The related interest-crediting obligations would then consist of the crediting of interest in an amount comparable to the payoff of the hedge. If actual policyholder persistency matches assumed persistency when the hedge positions were first opened, then the hedge payoff will match the interest credits quite closely with static hedging and will show some variance with dynamic hedging. The coupons on the fixed-yield investments would support the underlying principal guarantees.

This investment risk profile is similar to that with fixed-rate interest guarantees if the index-based interest crediting were for the same amount as if the hedge budget was used for fixed-rate crediting. Even when the index-based interest crediting varies, as it certainly will, the risk is similar because the credited amount is financed by a comparable option payoff. The additional risk to the insurer versus that with a fixed-rate crediting annuity is that the cumulative floor guarantees may incur additional risk in the event of a sequence of low index-based interest crediting terms. This can be mitigated with the lower available minimum nonforfeiture rate for EIAs under SNFLIDA.

Obligations of the Insurer

The insurer is required to provide benefits as guaranteed in the annuity contract. These consist of currently declared crediting guarantees, minimum crediting guarantees in future interest crediting terms, and minimum cumulative contract value guarantees. These obligations are independent of the method in which the underlying funds are invested.

Method of Managing Interest Crediting

Interest is credited on the basis of a series of guaranteed declarations that are made at the beginning of each interest crediting term. In most cases this is annual, but multi-year guarantees are common, too. In the case of annual interest crediting, the insurer typically will broadly translate the interest that would have been credited for fixed-rate crediting into a hedge budget that is applied to the purchase of a call option that matches the index-based crediting that has been guaranteed. In particular, the affordable guarantee is determined as that which can be hedged within the hedge budget. An analogous method is typically used for the determination of index-based interest crediting guarantees in multi-year crediting guarantee annuities.

Profitability Profile

An insurer that effectively manages the ALM risk with the placement of appropriate index-based hedges can anticipate a profitability profile similar to that on a fixed-rate annuity. The tracking will be closest with static hedges and will have some variances with dynamic hedging. The greater dispersion of interest-crediting results on an EIA versus a fixed-rate annuity will broaden the range of potential account values and this will have an impact on profitability, but the mean results should be similar. An aspect of potential reduced profitability is that the cumulative guarantees could come into play with an extended period of low index-based interest crediting. This low-probability event could have a moderate impact on profitability for the issuer of EIAs. The periodic (generally annually) crediting of floored (generally at 0%) interest avoids the cumulative-loss risk problems that exist in VAGLBs. The occurrence of even just a few positive crediting periods either eliminates the loss or greatly mitigates it.

Capital Structure

The regulatory capital requirements for an issuer of EIAs are similar to those for fixed-rate annuities because the risk profiles are similar. The business risk (C-4) and the market value liquidation risk (C-3) requirements are the same as for a fixed-rate annuity, in recognition of the essentially similar risk profiles. The investment risk (C-1) requirement is identical for the fixed-yield investments and is consistently carried forward for the EIA hedging instruments. In the latter case, the capital requirements for static hedging are based on the credit rating of the counterparty, just as for all other investments. If dynamic hedging is used, an insurer may hold additional capital in recognition of the variability of hedging results, but this is compensated for by the lower mean cost of dynamic hedging versus static hedging.

Comparison with Fixed-Rate and Variable Annuities

The comments above generally described the method of managing the EIA risk and the roots of the method, which is based on techniques used for other fixed annuities. The reason for the similarity in product financial management is the similarity of the product to a fixed-rate annuity.

The practices differ in almost all respects from the practices for variable annuities because of the difference in the nature of the risk. An EIA is a product with guarantees that must be supported by the insurer's general account investments, whereas a variable annuity is a pass-through product that transfers the investment risk to the purchaser through a separate account mechanism.

Summary Observations

From a technical perspective we have noted that an EIA provides to a purchaser guarantees and other conditions that are quite similar to those on a fixed-rate annuity. Similarly, the method in which an insurer financially manages the product and realizes financial results is essentially the same as that for a fixed-rate annuity. The combination of these perspectives indicates that nonregistered EIAs operate like fixed-rate annuities and thus have characteristics that support their status as nonregistered products.

Sincerely,

/S:/
Dave Sandberg
VP of Life
American Academy of Actuaries

Cc: Keith Carpenter and William Kotapish