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Proposal to Modify Existing Statutory Regulation for In-Force Synthetic GIC Business

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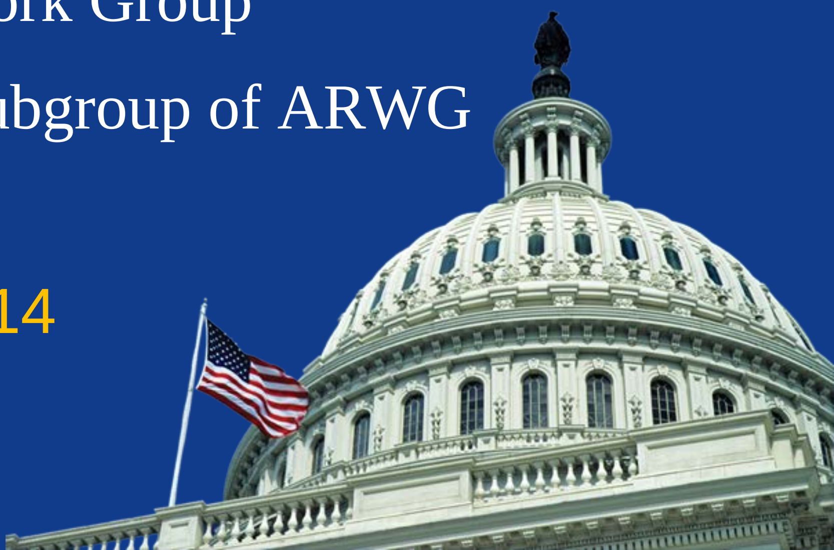

What is a Synthetic Guaranteed Investment Contract (GIC)?

- Participating contract designed to transfer most risk to plan participants through the crediting rate formula
- The product was developed in the mid-1990s in response to plan sponsor concerns regarding ownership of assets
- Synthetic GIC is a group annuity contract or other agreement that establishes the insurer's obligations by reference to a segregated portfolio of assets that is not owned by the insurer
- Investment guidelines typically control the types, allocations, maturities/ durations, and quality of assets allowed in the segregated portfolio
- The insurer provides a book value withdrawal guarantee for most participant-initiated payments and for plan sponsor-initiated payments under a pooled fund arrangement subject to advance notification requirements
- Claims occur only after all the market value of the segregated portfolio is exhausted
- Typically an "evergreen" contract with no stated maturity date; however, the segregated portfolio of assets is generally managed to a target duration

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Pooled Funds and Synthetic GICs

- A pooled fund is an arrangement in which multiple unaffiliated employer sponsored plans invest in a shared trust
- Insurer issues Synthetic GIC to shared trust and this is referred to as a pooled fund contract
- Similarities of a pooled fund contract to a non-pooled fund contract
  - Participating contract designed to transfer most risk to plan participants through the crediting rate formula
  - Segregated portfolio of assets not owned by insurer
  - Investment guidelines for segregated portfolio
  - Book value withdrawal guarantee for most participant-initiated payments
- Differences of a pooled fund contract to a non-pooled fund contract
  - Book value withdrawal guarantee for plan sponsor-initiated option to exit the shared trust subject to advance notification requirements, typically ranging from 6 to 24 months
  - Exposure to many plan sponsors, typically small businesses, provides the potential for risk diversification to the insurer

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Synthetic GIC Proposed Changes to Statutory Valuation Methodology (Nov. 2012)

- Determination of the Discount Rate
  - Substitute 50% Treasury-based spot rate plus 50% corporate bond index spot rate for 105% of the Treasury spot rate
    - Corporate bond index combines two indices
      - Barclays Short Term Corporate Index (less than 1 year to maturity)
      - Barclays U.S. Corporate Investment Grade Bond Index (greater than 1 year to maturity)
- Deduction to the market value of assets
  - Eliminate the deduction provided
    - Asset default risk borne by the plan participants
    - Transfer of risk reflected in contractual provisions
  - No change to the deduction if:
    - Asset default risk borne by the insurance company

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LATF Feedback on Proposed Changes

- LATF requested that the Subgroup research reserve requirements for similar products issued by banks and the prevalence of two practices at the time the Model Regulation was written: (1) use of derivatives in segregated portfolios for replication purposes and (2) plan sponsor book value put options in pooled fund contracts
  - Subgroup responded at Spring 2013 NAIC meeting and LATF provided further direction
- LATF requested that the Subgroup expand the proposal to clarify and strengthen the valuation requirements for Synthetic GICs issued to pooled funds within the existing deterministic valuation framework and to provide more transparency in the Plan of Operations
  - Subgroup provided guiding principles to expand the proposal and discussed them with LATF on a December 2013 conference call
  - LATF requested that the Subgroup proceed with expanding the proposal based on the guiding principles

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Synthetic GIC Additional Proposed Changes to Statutory Valuation Methodology

- Clarify and strengthen the valuation requirements for pooled fund contracts
  - Reflect known cash flows associated with the plan sponsor book value put option
  - Reflect a prudent estimate of projected future cash flows associated with the plan sponsor book value put option based on experience and other relevant criteria
  - Use a single valuation rate equal to the lesser of the expected return from segregated portfolio of assets and the blended spot rate based on the duration of the segregated portfolio of assets
- Expand the actuarial memorandum requirements related to withdrawal risks
  - Consider the impact of any dynamic lapse assumptions
  - Consider sensitivity testing the prudent estimate of projected future cash flows associated with plan sponsor book value put withdrawals
- Expand the requirements in the Plan of Operations for pooled fund contracts
  - Describe criteria used by insurer in approving pooled fund and investment manager
  - Describe risk mitigation techniques used by insurer for pooled fund contracts

Impact on Reserves for Pooled Funds

- Proposal results in pooled fund reserves that are greater than or equal to single plan reserves
  - Pooled fund reserves emerge earlier than single plan reserves as MV/BV ratios fall
  - Pooled fund reserves are significantly larger than comparable single plan reserves

- Pooled fund reserves increase as the projected plan sponsor put option exercise rate assumption increases

- Pooled fund reserves are consistent with the present value of expected future claims

Key Aspects of Synthetic GIC Proposal

- Retains consistency with solvency focus of statutory regulation
- Allows for a more consistent liability valuation with the underlying assets
- Recognizes that most risks are retained by the plan participants
- Produces appropriate reserves reflecting contract risks across economic environments
- Addresses the LATF feedback expressed to the Subgroup