AMERICAN ACADEMY of ACTUARIES

Report on Revenue Sharing from the American Academy of Actuaries' Variable Annuity Reserve Work Group

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Variable Annuity Reserve Work Group

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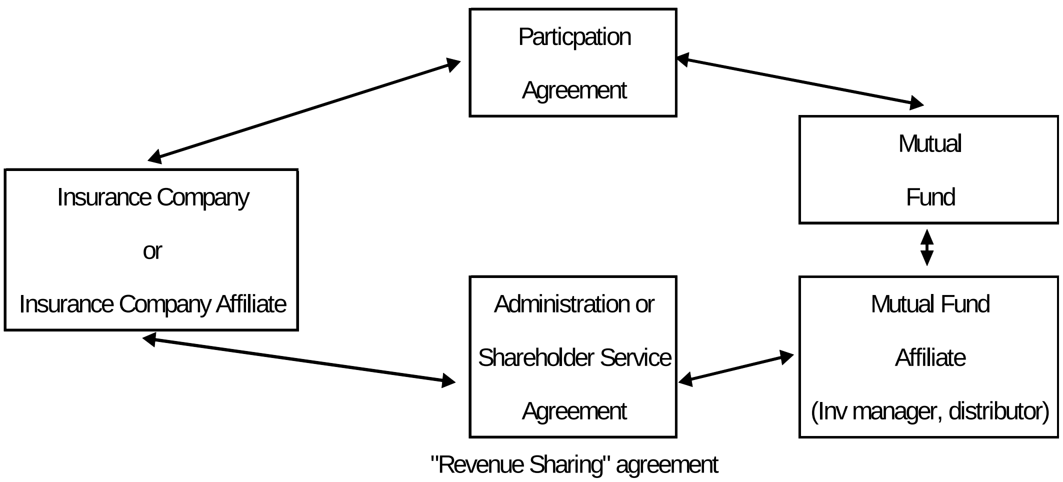
Background
This report is intended to help the reader understand the source of revenue sharing payments, why they are paid, the structure of revenue sharing agreements, the likelihood of revenue sharing payments being terminated and the options available to insurers in the event payments are terminated.

General Description of Revenue Sharing
Revenue Sharing, for purposes of these requirements, means any arrangement or understanding by which a mutual fund company affiliate[1] responsible for providing investment or other types of services to the underlying mutual fund in a variable annuity makes payments to the insurance company (other than distribution of earnings to an insurance company that owns the mutual fund company affiliate)[2]. Such payments are typically in exchange for administrative and/or distribution services provided by the insurance company, such as shareholder services, marketing, distribution, sub-accounting, sub-transfer agency and/or recordkeeping.

General Structure of Agreements
The relationships between entities in many revenue sharing agreements (often called administration or shareholder service agreements) are generally similar to the structure illustrated by the following diagram:



The Participation Agreement allows the insurance company to purchase shares of the mutual fund on behalf of its separate accounts to fund annuity contracts. The Revenue Sharing agreement compensates the insurance company for shareholder and other services (which may include distribution services) that it provides. Sometimes the Revenue Sharing agreement is contained within the Participation Agreement, but most often it is a separate agreement.

Participation agreements are between the insurance company, an affiliate of the mutual fund (such as its investment advisor or underwriter), and often the mutual fund itself. Revenue sharing agreements are usually between the insurance company and a mutual fund affiliate. The mutual fund is generally not a party to the revenue sharing agreement.

Since the mutual fund is generally not a direct party to the revenue sharing agreement, the revenue sharing fees may not be directly linked to mutual fund charges. In any event, revenue sharing fees are closely related to the mutual fund charges. Participation agreements and revenue sharing agreements should be viewed as “sister contracts” in that (a) revenue sharing contracts usually acknowledge the participation agreement, and (b) an insurance company would usually not enter into one without the other.

Purpose of Revenue Sharing
The broad purpose of revenue sharing is to compensate the insurance company for services that are provided on behalf of the mutual fund. The underlying mutual fund incurs expenses every time it processes a request for a sale, administration or redemption of shares. The variable account (established and administered by the insurance company) aggregates all contractholder purchase, redemption, and transfer requests and submits one net purchase/redemption request to the underlying mutual fund each day. Thus, from the underlying mutual fund's standpoint, the variable account is a single shareholder. When the variable account aggregates transactions, the underlying mutual fund is relieved of incurring the expense of processing individual transactions. The expense is incurred by the insurance company.

[1] It is possible in some situations for payments to be made directly by the mutual fund company or the mutual fund itself.
[2] Insurance company means the insurance company or an insurance company affiliate.

The insurance company also pays the costs of selling the variable annuity contract, which benefits the underlying mutual funds by providing contractholders with access to the underlying mutual funds.

Examples of Services for which Revenue Sharing is Paid:

- Administrative functions such as processing individual purchases and transfer requests;
- Calculating unit values and performance results;
- Preparation and mailing of confirmations and quarterly account statements:
- Maintenance of individual shareholder records, maintenance of an 800 number and associated staffing expenses.
- Printing costs for fund prospectuses used in sales solicitations;
- Printing and distribution of advertising materials, sales literature and annual reports.
- Sales activity and on-going servicing efforts by field personnel.
- Expenses for educational events and providing continuing education.

Observations

1. <u>The insurance company owns the assets underlying the variable annuity and holds them on its balance sheet</u>. The insurance company selects the funds that are offered within the product, although the customer generally makes the investment allocation decisions for his or her particular contract.

    a. As owner of the assets, the insurance company holds the assets on its balance sheet and exercises considerable control over which funds are offered and under which conditions.

    b. Some funds may be managed by a company affiliated with the insurance company (perhaps with a sub-advisory agreement with an independent investment adviser). Other funds may be sponsored by a non-affiliated investment advisor with the same fund being offered in competing products of other insurers.

    c. Any change in the fund offerings is subject to the necessary regulatory approvals. The substitution of one fund for another or the combining of several investment options into a single fund is generally more complicated and time-consuming than adding a new option or closing an existing investment option to further allocation by contract holders. Substitution of one fund for another typically involves a substitution application to the SEC and possibly requires underlying variable annuity contractholder approval.

    d. The mutual fund agreement may contain restrictions under which further purchases are curtailed. For example, the mutual fund may no longer be available for new sales if the mutual fund is adversely impacted by sales or redemptions from the insurer's products. Likewise, the insurance company can curtail the flow of cash into a particular fund or funds (e.g., by limiting the exposure of that fund to contractholders or by closing the fund to new money).

2. <u>Since mutual funds are an integral part of a variable annuity, the business practices of the mutual fund industry should be considered in the discussion of revenue sharing.</u>

    a. The return for an owner of a variable annuity contract depends not only on the product charges but also on the mutual fund expenses on the selected investment options.

    b. The broad purpose of revenue sharing is to compensate the insurance company for the services performed by the insurance company.

    c. The revenue and profitability for an insurance company on its variable annuity products depend not only on the revenue stream arising from the product charges but also the revenue-sharing income arising from the underlying mutual funds. These two revenue streams reimburse the insurance company for the servicing and distribution expenses associated with the variable annuity products.

d. One possible source of revenue sharing to compensate service providers is the 12b-1 fee[3] charged by the fund. The use of 12b-1 fees is quite prevalent in the mutual fund industry. Since first introduced in the early 1980's, the amount of these fees has risen from a modest amount to over $10 billion in 2004. According to the ICI[4], these fees are used for the following purposes:
   i. 52% for ongoing shareholder services
   ii. 40% as compensation for initial sales efforts
   iii. 6% as payment to fund underwriters, and
   iv. 2% for promotions and advertising.

3. Unlike most financial providers, the typical mutual fund has no employees and out-sources all services to affiliates or outside parties. It is a common practice in the mutual fund industry to compensate others for distribution and servicing functions.

   The principal functions outsourced by the fund's Board of Directors[5] are:

   a. Investment Advisor: manages the fund's portfolio according to the objectives and policies described in the fund's prospectus.

   b. Principal Underwriter: sells fund shares, either directly or through other firms (e.g., broker-dealers)

   c. Administrator: oversees the performance of other companies that provide services to the fund and ensures that the fund's operations comply with applicable federal requirements.

   d. Transfer Agent: executes shareholder transactions, maintains records of transactions and other shareholder account activity, and sends account statements and other documents to shareholders.

   e. Custodian: holds the fund's assets, maintaining them separately to protect shareholder interests.

   f. Independent Public Accountant: certifies the fund's financial statements.

4. The mutual fund charges include provision for certain services (distribution, shareholder or transfer agent services, general administration, etc.).

   a. The annual operating expenses of a mutual fund are typically deducted from the net asset value of the shares. These expenses can be identified as management fees (to compensate the investment manager for its services), a charge for other services (to compensate for administration of the funds and the servicing of its customers), and possibly a 12b-1 fee (to compensate distributors and to pay for marketing costs)[6].

   b. Some funds include a charge assuming that the Transfer Agent is processing service requests from individual customers (that is, a retail type of cost structure) whereas other funds are structured so as to process "bundled" service requests (that is, an institutional type of cost structure).

5. Since the revenue sharing reflects the services being performed by the insurance company, there will be variations in the types of agreements between the insurance company and the mutual fund affiliate (or one of its service providers). This variation among agreements (for example, distribution-related or servicing-related), as well as the confidentiality of most agreements, makes it more difficult to provide universal, specific statements regarding the contents of revenue sharing agreements.

   a. The amount of revenue sharing companies receive varies dramatically (in dollars and in basis points of account value). In part, this reflects the variations in cost structure of the mutual fund (e.g., the class of shares offered).

   b. One major determinant of the terms of revenue sharing agreements offered by the fund manager is the amount of money that is expected to be placed under management by the particular insurance company.

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[3] The 2005 ICI Fact Book on page 144 defines 12b1 Fee as "a mutual fund fee, named after the SEC rule that permits it, used to pay distribution costs, such as advertising and commissions paid to dealers. If a fund has a 12b-1 fee, it will be disclosed in the fee table of a fund prospectus."
[4] See Investment Company Institute "2005 ICI Fact Book" page 126.
[5] 2005 ICI Fact Book p117
[6] See Investment Company Institute "2005 ICI Fact Book" page 126.

An insurance company that places larger amounts under management may be able to negotiate better terms but not higher fees, than one placing a smaller amount under management.

c. Different fund managers have different philosophies as to pricing their products to consumers. This naturally has an effect on what revenue sharing is paid to insurance companies.

d. Insurance companies have differing product features and experience (such as, surrender rates), which can affect the amount of revenue sharing.

e. Supply and demand may have an effect on the revenue sharing negotiations.

f. Some revenue sharing agreements may combine payment for distribution, service, and administration whereas other agreements may include only payment for administrative expenses.

6. <u>The agreements between the mutual fund and *direct* service providers (such as the asset manager, fund administrator, and distributor) are subject to periodic review and renewal by the fund's Board of Directors</u>. This review would usually include fund participation agreements, because such agreements directly authorize the ownership and trading of mutual fund shares by the insurance company. The fund administrator and distributor are paid by the fund and are responsible for their respective services; in turn, they sub-contract with insurers because of the unique role of the insurance companies in providing shareholder service and distribution functions.

   As described in the ICI Fact Book on page 119 "Directors must exercise the care that a reasonably prudent person would take with his or her own business. They are expected to exercise sound business judgment, approve policies and procedures to ensure the fund's compliance with federal securities laws, and undertake oversight and review of the performance of the fund's operations as well as the operations of the fund's service providers (with respect to the services they provide to the fund)." And perhaps most importantly, they must represent the interest of shareholders.

7. Since mutual fund agreements are subject to periodic review and renewal, it may be too restrictive <u>to require that revenue sharing arrangements must be guaranteed in order to be reflected in the modeling of future revenue.</u>

a. The projections proposed under VACARVM are intended to be an economic model of the business. Maintenance and overhead expenses of the insurance company are included in the model, including those associated with the services supported by the revenue sharing.

b. It is logical to assume that the revenue sharing reimbursing the insurance company for these services should also be included in the model, with appropriate margin for uncertainty. This margin should include an estimate of how the amount of revenue sharing would be impacted by possible changes to the revenue sharing agreement

c. VACARVM provides that assumptions are to be based on Prudent Best Estimates Some have suggested that revenue sharing should not be taken into account unless it is guaranteed to a conservator (or other statutory receiver) in the event of failure of the insurance operation. This suggestion is inconsistent with a Prudent Best Estimate assumption of assuming an on-going flow (with margins for uncertainty) in that experience shows that mutual fund companies <u>have traditionally compensated others for the services provided</u>. Requiring revenue sharing to be guaranteed also ignores the options listed below in paragraph 7g, which are available to the insurance company in the event the revenue sharing is terminated.

d. Potential changes to the revenue sharing agreement should be considered in setting the Prudent Best Estimate assumption. One of the potential changes to the revenue sharing agreement that should be considered is the ability of the mutual fund affiliate to terminate the revenue sharing for new and/or inforce money. The effect of the termination of the revenue sharing agreement depends upon the terms of the agreement. While some agreements provide that revenue sharing continues as long as the underlying fund continues to be an investment option in the product after the date of termination for new allocations to the fund, not all agreements do. A Participation Agreement may allow the Fund to terminate the Agreement with respect to new purchases in the event the insurer suffers a "material adverse change in its business, operations, financial condition, or prospects."

e. Note, however, that termination of the revenue sharing for new money may or may not mean the insurer's right to continued payments is terminated, as some agreements continue payments as long as assets remain in the underlying mutual fund.

f. Examples of possible termination provisions we have seen include:

- The term of the agreement is for X years unless terminated earlier by breach of contract or by law. At the end of X years, the agreement renews each year for a one-year term without further action by either party, unless either notifies the other, no later than 90 days before the close of the term or any anniversary, of its intent to terminate this agreement.
- Without notice in the event of bankruptcy or dissolution, the appointment of a trustee or rehabilitator, etc… A party commits fraud or commits some other intentionally illegal act.
- At the option of the Insurance Company upon formal proceedings against the Mutual Fund Affliliate.
- At the option of the Mutual Fund Affliliate upon formal proceeding against the Insurance Company.
- At the option of either party upon the other party's material breach of any provision of the agreements.
- At the option of the Mutual Fund Affliliate if the Insurance Company has suffered a material adverse change in its business.
- At the option of the insurance company, if the advisor/underwriter has suffered a material adverse change in its business
- Upon assignment.
- Upon termination of the Participation Agreement.
- By either party with 60 days notice

g. Potential options available to the insurance company in the event the revenue sharing payments are terminated include:

- Legal action in the event the agreement specified that revenue sharing was to continue payments post-termination.

- In the event the agreement does not specify that revenue sharing is to continue payments post-termination, legal action may still be a possibility, since the fund is collecting charges for administration and is not having to provide these services. In this case the insurance company could make the argument that it is entitled to payment.

- Substitution of an alternative fund with sufficient revenue sharing.

- Walling off the fund for new money deposits.

8. Revenue sharing is too important an item to ignore if the projections for <u>reserves are to capture the true economics</u> of the variable annuity contracts. The guidance provided in the Academy's Variable Annuity Reserve Work Group recommendations provides a reasonable framework under which to recognize this element of cash flows.

   We note that Principle 2 of the 01/25/06 AG VACARVM exposure states "The methodology utilizes a projected total statutory balance sheet approach by including all projected income, benefit and expense items related to the business in the model." In addition, Principles 3 & 5 provide guidance regarding for establishing the assumptions to be used in measuring the risks to which the company is exposed.