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

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What is a Synthetic 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
- 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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Existing Regulation and Issues

- Existing Statutory Regulation
  - NAIC Synthetic Guaranteed Investment Contract Model Regulation
    - Reserve equals excess, if any, of (1) PV of guaranteed benefits using spot rate supportable by the expected return from segregated portfolio but not greater than 105% of the treasury spot rate over (2) market value of assets less deductions
    - Partial reproduction in Appendix A-695 of the NAIC APPM
  - NY Regulation 128
  - CT Regulation 38a-459
  - Some states have a percentage of premium accumulation as the reserve
- Issues
  - Reserves increased significantly at year-end 2008 due to low Treasury rates and high spreads on investment grade corporate bonds
  - Temporary relief granted by some states
  - Need for a permanent solution within the statutory framework

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Synthetic GIC Proposed Changes to Statutory Valuation Methodology

- 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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Selection of Corporate Bond Index

- Selection of Corporate Bond Index
  - Corporate Bond Index Requirements
    - Should be widely used in practice
    - Investment grade corporate bonds; no treasuries
  - Barclays US Corporate Bond Index
    - Widely used in portfolio management
    - Commonly used as a component of the benchmark for the asset portfolio supporting Synthetic GICs
    - Provides more reference rates across maturity spectrum than alternative indices
    - Barclays also offers a short-term index; important since corporate bond indices have a minimum one-year-to-maturity requirement

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Blending of Corporate Bond Index and Treasury Rates

- Blending of Corporate Bond Index and Treasury rates
  - Principles from general account valuation
    - Consider plan type and guarantee duration
  - Barclays historical spread decomposition for the U.S. Corporate Investment Grade Bond Index
    - Components of investment spread include default cost, risk premium and liquidity cost
    - For the period Jan 2007 through May 2012, the average default cost as a percent of the total investment spread is 46% (Barclays)
  - Review of historical Treasury rates and bond index rates

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Historical Comparison of 50/50 Blend and 105% Treasury

Historical Comparison of 50/50 Intermediate Corporate and 5-7 Year Treasury Index and 105% of Treasury

The 50/50 blend accommodates historical and recent financial market environments

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Impact to Reserve Based on Sample Contract and Assumptions

- Proposal lowers reserves on historical valuation dates when Treasury rates are low and credit spreads are relatively wide
  - Due to PV of guaranteed contract benefits responding to changes in market conditions to a greater degree than in existing regulation
- Proposal generates similar reserve patterns with respect to assumptions; reserves increase as
  - MV/BV ratio deteriorates
  - Current crediting rates increase
  - Duration shortens (lower discounting rate, shorter discounting time)

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Key Aspects of Synthetic GIC Proposal

- Retains consistency with solvency focus of statutory regulation
  - Objective
  - Conservative
- Allows for a more consistent liability valuation with the underlying assets
- Recognizes that most risks are retained by the plan participants
- Aligns asset deductions with AVR requirements for separate accounts

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Questions?

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