To: Interstate Insurance Product Regulation Commission (IIPRC) Management Committee

From: Craig Hanna, Director of Public Policy, American Academy of Actuaries

Date: January 6, 2010

Re: Written Comments for 1/11 IIPRC Teleconference

Attached are comments from the American Academy of Actuaries' Life Products Committee. Barbara Lautzenheiser, a member of the committee, will present these comments orally at the January 11 IIPRC Management Committee teleconference, with respect to Additional Standards for Guaranteed Living Benefits and Guaranteed Minimum Death Benefits for Individual Deferred Annuities.

Should you have any questions regarding this submission, feel free to contact me.

Craig Hanna
Director of Public Policy
American Academy of Actuaries
1850 M Street, NW
Ste. 300
Washington, DC 20036
(202) 223-8196

To: Mary Jo Hudson, Chair, Interstate Insurance Product Regulation Commission Management Committee

From: American Academy of Actuaries' Life Products Committee

Date: January 6, 2010

Dear Director Hudson:

The American Academy of Actuaries' Life Products Committee (the Committee) appreciates the opportunity to comment on the Interstate Insurance Product Regulation Commission (IIPRC) Guaranteed Living Benefit (GLB) proposed standards for individual deferred annuities. Our comments are also intended to similarly apply to Guaranteed Minimum Death Benefits.

Background

GLBs provide guaranteed minimum benefits, most commonly lifetime withdrawal benefits, under an annuity contract. Such benefits are most commonly included in variable annuity contracts. GLBs are usually a percentage of a guaranteed withdrawal amount which is in most cases at least as great as the account value of the annuity at its highest point since contract inception, and could in some cases be set at an amount larger than that. Charges for a GLB are generally deducted from the account value monthly.

The IIPRC GLB standards, as currently drafted, would allow insurers to terminate the GLB if an annuity is sold to certain types of new owners (principally to an institutional investor). In the event that a sale is allowed, the life on which the annuity is based would remain the same after any sale that continues the GLB.

Proponents of this provision of the draft standard have argued that it is important to be able to terminate the GLB if the annuity is resold to an institutional investor, because charges for the benefit would need to be higher for all contract owners in the absence of such a provision. This assertion is based on the premise that the language in most GLBs available in the marketplace today does not allow their resale to an institutional investor, so charges for GLBs containing language allowing the resale would increase over what they are today (or GLB features would not be available at all).

Others have argued that a contract owner should be able to sell the annuity to an institutional investor with the GLB intact because the institutional investor may be willing to pay an amount greater than the contract's cash surrender value and that particular contract owner should not be denied that opportunity. Proponents of this position appear not to be convinced that the GLB charges would increase over what they are today, or if they did increase it would not be by much.

Analysis of the Provision

The Committee has done a preliminary analysis of this provision and would like to offer two comments based on this analysis:

1. **Permitting institutional investors to purchase GLB annuities will increase the initial price of the contract's GLB feature.**

   Although the terminating contract holder may benefit from the ability to later sell their contract at a price exceeding the cash surrender value, GLB charges at the time the contract is purchased would need to be increased to cover the additional costs of an institutional investor owning such contracts. There are two major reasons for this.

   a. **Individuals have different preferences than institutional investors.** Individuals have interests in both the benefits of the underlying annuity and the protection provided by a GLB against outliving their assets. Consequently, they are likely to use various features of the product as their individual needs dictate and/or change. Their primary interest in the GLB is to guarantee a lifetime income, and so their timing of withdrawals could be independent of underlying annuity investment performance. Also, an individual may want to maintain a less risky investment allocation in order to keep the flexibility of being able to take the full cash value in the event of a financial emergency.

      In contrast to the behavior of individuals, institutional investors may view the arrangement as a fixed-cost investment that will pay off either in lifetime income benefits or a strongly-growing account value. Consequently, reallocating to the riskiest available investments could be an effective strategy. An institution will value differently the tradeoffs among longevity protection, the use of cash values, and product tax implications. Pricing the GLB feature to cover the cost of potential institutional investor behaviors would necessitate a higher charge than pricing the GLB feature to address individual behaviors. This risk preference differential has the potential to raise the GLB charges significantly, as shown below.

   b. **Permitting institutional investors to purchase GLB annuities will introduce concentration of risk resulting in additional costs.** There is increased risk due to the potential of a few institutional investors having a large percentage of the overall market, since this increases the risk that such investors might exercise a certain contract right for an entire block of contracts at the same time. Concentration of risk requires more extensive hedging (mitigation of risk measures) and also increases the possibility that hedging alone may not be sufficient to cover the risk should a very unlikely event occur.

Consider an annuity that is priced on the basis of experience with individual contract owners. The experience might show, for example, that contract owners' decisions to begin annuity payments are determined mostly by an annuitant's age. It is likely, however, that institutional contract owners' exercise of withdrawal rights would be determined mostly by the economic environment. Strategies to hedge that work for a block of annuity contracts owned entirely by individuals are not the same as those needed if a significant part of the block were owned by institutions. If the latter situation were hedged, the hedge might be (1) more expensive and (2) less effective in a severe economic crisis, such as began in the second half of 2008. In the latter case, under the reserving and the risk-based capital rules for variable annuities, the reserve and capital requirements would be much higher and thus the risk charges and other charges associated with the GLB would have to be increased, likely by a significant amount.

2. **Permitting institutional investors to purchase GLB annuities will require subsidies that are unfavorable to some consumers.**

   The increased costs of hedging and possible limitations on investment allocation alternatives within the contract if institutional investors were allowed to purchase the GLB will be worthwhile only to those contract owners who actually sell the contract. In any economic environment the annuity contracts that will be most valuable to institutional investors will be the large contracts that are the most "in the money," (i.e., will have the largest excess of the present value of future guaranteed withdrawals over the account value) which belong to the healthiest individuals who are likely to live the longest. Other contract owners may not be able to sell the annuity for more than the account value. Many of these contract owners would not even be approached by institutional investors and hence not have the option to sell their contracts. However, all contract owners at the time of purchase would have to pay the increased risk charges and accept added restrictions on investment allocation choices. This would create a subsidy from owners of smaller contracts to owners of larger contracts. If GLB charges can be increased during the life of the contract, there could be a further subsidy from consumers in poor health to those in good health.

In summary, individuals and institutions have different financial objectives, different tolerances for risk and different needs for liquidity over periodic payments. All of these create different policy utilizations and outcomes and increased costs.

Quantification of the Increased Costs

Given the time constraints in providing this preliminary analysis, the Committee has not attempted to quantify the costs associated with allowing the resale of GLB annuities to institutional investors. However, two preliminary rough estimates based on a common GLB product design for Guaranteed Minimum Withdrawal Benefits indicate:

1. If an individual risk preference for investments is a 50/50 split between stocks and bonds and the institutional preference is for a 70/30 split, the extra risk exposure would increase the cost to the insurer of providing the GLB feature by approximately 35%.

2. Preliminary analysis shows that if institutional investors purchased all of a company's GLB annuities that were 25% "in the money" (present value of guaranteed withdrawal amount is 125% of the account value) then the cost to the insurer of providing the GLB feature would increase by approximately 50%.

These are very rough, preliminary estimates that do not take into account the compounding of the interactive effect that these two risks would have, but they give an indication of the potential financial effect of permitting the unrestricted sale of GLB annuities to institutional investors.

In addition, the cost impact could vary significantly depending upon the effect of the following variables:

Variables that might decrease the cost impact:

- Whether small policies are included in the insurer's market and then whether those policies would be purchased by an institutional investor
- Extent of policy owner awareness of the availability that their policy could be sold
- Policy owner interest in selling
- The portion of contract owners who qualify for sale to an institutional investor on the basis of health status, and average policy size
- Based on the financial markets, the GLB "in the money" point at which making a purchase is attractive to an institutional investor

Variables that might either increase or decrease the cost impact:

- Benefit design (e.g., limitations on contract withdrawals, limitations on allocation of funds within the underlying annuity, or a minimum rate at which the GLB increases annually)
- The demographic characteristics of an insurer's market (e.g., policy owner's age, marital status, other financial investments, financial knowledge, etc.)
- The persistency and withdrawal patterns assumed in the basic pricing of the GLB
- Other less important factors

If the IIPRC Management Committee feels it would be helpful to have a more extensive development of costs and other impacts or a discussion of the additional risk issues that should be considered, the Committee would be happy to do so, if additional time to do so is allotted.

Thank you for the opportunity for the American Academy of Actuaries Life Product Committee to provide input on this issue. We would be happy to answer any questions you may have.