What are separate account index linked products?

Separate account index linked products are very similar to equity indexed annuities (e.g., cap on positive index performance), but have no minimum floor as typically required to meet nonforfeiture law requirements. Under the most popular design, an insurer absorbs negative index performance within a buffered range (first 10%, e.g.); alternatively, a “hard floor” design limits excessive losses to contract holders beyond the fixed rate floor (e.g., insurer absorbs loss if more than 5%). This buffered range (or floor) essentially operates as a partial guarantee of the investment, but only at the index maturity date. Excess negative index performance beyond the buffer is passed through to the contract holder; this differs from a hard floor approach where the insurer retains that adverse rate risk.

What concerns do regulators have related to separate account index linked products?

The regulator concerns are focused in three areas: 1) the mischaracterization of these products as variable annuities; 2) the approaches used to fund these products are not consistent with those used for variable annuities; and 3) treating these products as variable annuities leads to an inappropriate application of nonforfeiture standards.

1) **Mischaracterization:**

The products may be characterized as variable annuities, possibly combined with true (unitized) variable options, but unlike a (true) variable option, index option benefits do not “vary according to the investment experience of a separate account.”

   a) The separate account assets of these funds do not contain actual equity index shares and the investment experience earned is not based directly or entirely on the investment experience of the separate account.

   b) On the index maturity date, the account value is driven by the index performance (subject to the cap and buffer, or floor); designs can have interim valuations that do not vary based on the index performance, but on “fair valuing” of different asset/investment classes which are not driven by the investment experience of the separate account.

   c) Unlike true variable accounts, these accounts maintain extensive transfer prohibitions and/or restrictions between the index term start and end dates (defined as the interim period).

   d) Investment experience crediting at the maturity date and on interim valuations is not determined consistently. Interim values (between the term start and end dates) often prorate or accrue the cap and buffer rates. These daily valuations commonly pass through quasi-market value experience from hypothetical classes of assets which represent distant investment instruments held in both the general account and separate account (i.e., again, benefits do not vary according to the actual investment experience of the separate account).
2) **Funding Approaches:**

   a) Non unit-linked separate accounts, and perhaps the general account, are used to fund the index option; assets in the separate account usually are described as non-insulated.

   b) Hedging is done through the general account or separate account, also leading to varying distributions of assets between accounts.

   c) Ongoing (different) types of true-up transfers to/from separate account may be made.

3) **Application of Nonforfeiture Standards**

   a) The model regulation definition of variable annuity is not met by this index account, since benefits do not “vary according to the investment experience of a separate account or accounts maintained by the insurer as to the policy or contract” (taken from Model #250). A true variable annuity account varies by the experience of the separate account, while the hybrid annuity account varies by hypothetical values, caps and buffers, or floors that have no direct correlation to the experience of the separate account.

   b) Per Section 7B of the model, nonforfeiture testing of index option benefits should, therefore, not be done using the variable annuity regulation. (The alternative, the Standard Nonforfeiture Law for Individual Deferred Annuities, which has minimum floor, also does not work for this hybrid.)

4) **Consumer Issues Other Than Nonforfeiture:**

   a) Interim values (i.e., surrender values) may be difficult to understand.

   b) It is unclear whether hybrid products are covered by guaranty funds, and, if so, the extent of that coverage. Guaranty fund coverage is an important consideration, because these contracts do not have separate insulated assets, as is the case with traditional variable annuities.

**Discussion Points for ILVA Subgroup and Interested Parties**

1) By definition, these product designs do not fit the current regulatory framework – they are hybrids, not totally fixed and not totally variable. What is the best way for the NAIC’s regulatory framework to be enhanced to provide appropriate and effective regulation of separate account index-linked products?

2) Specifically with regard to nonforfeiture, existing nonforfeiture provisions in NAIC model laws and regulations are inadequate to address such hybrid designs. What nonforfeiture standards should apply? Should separate account index-linked products be considered in the larger nonforfeiture project?

3) What is the appropriate approach to valuation of separate account index-linked products for statutory reserving and RBC purposes?

4) Are there other financial reporting issues that need to be addressed for such products (e.g., the geography issues that emerge where the general account and the separate account both hold assets backing the index-linked contract liability)?
5) What consumer protections are appropriate for hybrid products and are new rules needed to address the nuances of hybrid separate account products?