

# **EQUITY INDEXED PRODUCTS-- WHAT ARE THEY AND HOW DO THEY WORK?**

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## **EQUITY INDEXED PRODUCTS – AN INTRODUCTION**

This paper is written to bring the reader information on what equity indexed products are and generally how they work. Equity indexed products (EIPs) are defined as products that provide the policyholder with a right to receive higher values based on the growth of a stock index. This is similar to participation in the stock market index, typically subject to minimum interest rate guarantees. There are two types of EIPs--equity indexed annuities (EIAs) and equity indexed life insurance policies (EILs). This paper deals almost exclusively with EIA products. The EIL products are still too few and too new to the marketplace to have any real impact and would be better addressed in a separate paper.

The EIA policy structure is built on a standard fixed annuity design and an equity indexed amount is credited in addition to the basic fixed benefits. The equity indexed amount is granted to the policyholder after an initial term and uses one of the stock market tracking indexes. The equity indexed benefit allows the policyholder to receive an amount calculated on the basis of the tracking index, while the principal guarantee and minimum guaranteed interest crediting rate protects the underlying investment made by the policyholder.

Many insurance regulators have not had the opportunity to date to familiarize themselves with the management tools and systems developed to support EIAs. In contrast, many investment managers inside and outside of insurance companies have been using the types of investment structures required for EIAs for many years. The investments and investment techniques supporting EIAs use standard finance procedures. By learning what these are and what they are designed to accomplish, confusion and misunderstanding can be avoided.

This paper sets out the terminology and financial structures used by an insurance company's own investment personnel as well as outside fund managers. The paper should also be read knowing that as it is being published, there are new products coming onto the street that are different and sometimes more complex. A generation cycle for an EIA and the competing products offered by other segments of the financial services industry is not measured in years, but rather in weeks.

## **EQUITY INDEXED PRODUCTS - AN OVERVIEW**

The first equity indexed annuity product was sold in the United States by a single company in 1987. This product did not fair well in the marketplace and was subsequently discontinued. Several insurers offered EIAs in the early nineties--again without much marketing success. By 1994, however, the U.S. stock market had been bullish for several years. Following a brief pause in 1994, the market resumed its steady rise. With interest rates at low levels and with the stock market in a bullish mode, consumers often invested in excess of one billion dollars a week into mutual funds.

The annual returns earned on fixed annuities offered by the life insurance industry were not as competitive with the annual returns achieved by mutual fund products and the stock market. As a result, contemporaneous with the huge influx of new money into the stock market and mutual funds, new fixed annuity premiums declined annually in 1994, 1995 and 1996. The average rate of return for the years 1991 through 1996 on the Standard & Poor's 500 Composite Stock Price Index was 14.6%, even taking into account the negative return of 1.3% during 1994. By comparison, returns on fixed annuities hovered in the 4% to 7% range making them less attractive to the consumer.

Insurers began to realize they had to offer innovation, lower costs, better service, more choices and competitive purchase methods throughout their annuity product lines if they were to maintain--much less expand--their share of the retirement investments.<sup>1</sup> To meet this marketing challenge, Keyport Life Insurance Company introduced the first of the new equity indexed products on February 15, 1995. By September 1998, there were approximately 50 companies in the marketplace offering EIAs. EIP sales in excess of \$2 billion were reported for the first six months of 1998<sup>2</sup>, which indicates that EIPs continue to be even more popular than in the preceding years.

As noted above, an EIP is either an annuity or a life insurance product. Both the EILs and the EIAs generally provide the customary features associated with life insurance and annuity products respectively. What makes the EIP different is the addition of the equity indexed amount to the traditional policy benefits found in most annuities and universal products. This equity indexed amount allows the policy owner to potentially accumulate additional funds based on the appreciation of a selected stock market index over a defined period of time, while guaranteeing a minimum fixed rate on the invested principal. This guarantee distinguishes a fixed EIP issued by an insurance company from a mutual fund or bank EIP.

As with other fixed annuity products, insurers invest the EIA premium in a general account. This amount effectively secures the guarantee of principal on the EIA. A portion of the premium is used to buy call options of a stock index to which the EIA's equity index is linked, usually the S&P 500, which can then be exercised if the market is up on the call-option dates; the remainder is used to pay expenses.<sup>3</sup> A partial listing of EIPs offered by numerous companies has been compiled by Aurora Consulting, Inc. and can be located at <http://www.hpp-stl.com/aurora/eqproducts.html>.

#### *AN EIP INVESTOR PROFILE*

In separately completed surveys by two insurance product consulting firms in early 1997,<sup>4</sup> it was found that the typical EIA purchaser in the United States is between 45 and 65 years old with an average age of 55. The individuals purchasing EIAs do so as one of the components of their overall retirement planning strategy. The surveys found that typical customers did not want to place their retirement fund dollars totally into the stock or mutual fund market or some other more risky security investment because these consumers believe the risk of loss to their principal is too great. The EIA client generally is conservative, risk averse and is concerned about inflation and taxes. They are also a few years younger on average than the typical fixed annuity buyer.

The average dollar amount of an EIA is \$30,000. In 1996, EIA purchasers in the United States bought an estimated \$1.8 billion worth of products compared to other investors who invested \$16 billion in equity indexed products offered by the banks and mutual fund industry.<sup>5</sup> It is interesting to note that Europeans have for many years used EIAs as an investment vehicle to fund their retirement plan objectives.

#### *THE DIFFERENT TYPES OF EIAs*

EIAs typically offer traditional annuity benefits, such as tax free growth, guaranteed lifetime income, a guaranteed interest rate for at least the first year, or as in other annuity products, longer guaranteed interest rate terms of up to five years. After the initial guarantee period, interest rates are normally set on an annual basis. Although almost all of the EIA policy designs are for deferred annuities, a few of the EIA products are structured as immediate annuities.

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<sup>1</sup>This Selling Season's Hit: Equity-Indexed Annuities, Best's Review Life/Health, April 1997.

<sup>2</sup>Advantage Equity Index Sales Report 2<sup>nd</sup> Quarter 1998, The Advantage Group, St. Louis, Missouri.

<sup>3</sup>This Selling Season's Hit: Equity-Indexed Annuities, Best's Review Life/Health, April 1997.

<sup>4</sup>Milliman & Robertson, Inc. and NFC Consulting Group.

<sup>5</sup>Wall Street Journal, January 30, 1997, C1.

One important aspect of EIA designs is that they are more focused on longer term investment growth and insurance protection, not the liquidity needs of consumers. The EIA design often does not include a free withdrawal provision, but partial withdrawals, surrender without surrender charges, or otherwise reduced values are available under various circumstances. In a survey conducted by the NFC Consulting Group, it was found that of the existing products being marketed in the spring of 1997, 35% of the EIAs and 49% of the insurance companies offering EIAs did not offer the traditional free 10% withdrawal provision. Although many of the products do offer some sort of terminal illness or nursing care waiver, 22% of the insurers selling EIAs do not offer free liquidity in connection with their EIA products either through a free withdrawal provision or a waiver. As with other annuities, EIAs are not purchased by someone looking for quick liquidity.

### *BENEFITS TO THE CONSUMER*

An EIA typically offers two distinct advantages: first, an equity indexed amount which may increase the accumulation account based on the performance of the stock market index and, second, a guarantee of invested principal. The EIA allows the consumer to receive a return on invested dollars which is based upon the appreciation in the selected equity index without being subject to the downside risk associated with the securities markets.

As long-term retirement products, EIAs encourage the investor to stay with the issuing life insurer over an extended period of time. Generally, the terms for EIAs are for periods of five to seven years. There are a few EIA products which have a term of one year and some which have a term of up to ten years. A few of the recently introduced EIAs offer a choice of term lengths (e.g. 3, 5, 7 or 10 years).

Again, the liquidity provision is designed to keep the insured with the issuing insurer over the extended term instead of switching to a bank or mutual fund product or to another insurance product. Investors who are willing to trade the liquidity of bank and mutual fund products for the guarantee of principal are the individuals who are willing to make the investment into a long-term retirement product. Mutual fund products and bank products generally lack this feature. Therefore, if the stock market declines, the consumer is subject to principal loss with equity indexed bank and mutual fund products.

### *CHOICE OF INDEXES*

Most EIAs use the Standard and Poor's 500 Index, which excludes dividends. Standard and Poor's publishes several indexes with the S&P 500 being its most widely known index. Insurance companies using the S&P 500 Index in an EIA product must receive a license from Standard and Poor's for this purpose. Other EIA indexes include European and Asian stock market indexes.

### *EQUITY OPTION STRUCTURES*

Currently, there are five product designs or structures for equity options associated with EIAs. These structures are referred to as the point-to-point, ladder, high-water mark, low-water mark and ratchet (cliquet/annual reset) methods.<sup>6</sup> Index averaging methods are often applied to product designs. Each of the indexing structures offers consumers different choices based on their risk comfort level.

**Point-to-Point** methods credit interest as a portion of the percentage growth in the underlying index from the beginning of the term to the end of the term.

**Ladder** methods credit interest as a portion of the percentage growth in the underlying index from the beginning of the term to the end of the term with the additional guarantee that the recognized final index value will not fall below a specified index level if the index reached that level at specified points during the term. One or more "rungs" of a ladder may be specified. Measurements are typically done on anniversaries, but a more frequent basis is possible.

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<sup>6</sup>Report of the Equity Indexed Products Task Force, December 6, 1997.

**High-Water Mark** (or Discrete Look Back) methods credit interest as a portion of the percentage growth in the underlying index from the beginning of the term to the highest value the index has achieved at specified measurement points up to the end of the term. Typically, these measurement points are the anniversaries in the contract, but they could occur with greater frequency. Each of these measurement points could use some averaging technique. The high water method also is sometimes referred to as the discrete look back method, in recognition of the type of call option utilized to hedge it.

**Low-Water Mark** (or Discrete Look Forward) methods credit interest as a portion of the percentage growth in the underlying index from the lowest value the index has achieved at specified measurement points during the term to the index value at the end of the term. Typically, these measurement points are the anniversaries in the contract, but they could occur with greater frequency. Each of these measurement points could use some averaging technique. The low water method is sometimes referred to as the discrete look forward method, in recognition of the type of call option utilized to hedge it.

**Ratchet** (or Cliquet/Annual Reset) designs credit index-based interest to the current contract value periodically throughout the term. Variations of the design are used, such as the method of accumulation, frequency of accumulation, length of guarantee of index change recognition, and minimum guaranteed interest.

#### *OVERALL PRODUCT FEATURES*

The following is a breakdown of common product features of EIAs which were available in the spring of 1997:<sup>7</sup>

| <u>Premium Type</u> |     | <u>Method of Calculation</u> |     |
|---------------------|-----|------------------------------|-----|
| Single Premium      | 62% | Annual Reset                 | 35% |
| Flexible Premium    | 38% | High-Water Mark              | 11% |
|                     |     | Point-to-Point               | 54% |

#### Length of Initial Term (Years)

|         |    |          |     |
|---------|----|----------|-----|
| 1 Year  | 8% | 6 Years  | 24% |
| 2 Years | 3% | 7 Years  | 30% |
| 3 Years | 5% | 8 Years  | 5%  |
| 4 Years | 3% | 9 Years  | 3%  |
| 5 Years | 8% | 10 Years | 11% |

#### *VALUING THE INDEX OPTION*

There are two components in the process of valuing the index option. The first component is to determine the valuation assumptions. The valuation assumptions are the interest rates of the assets purchased, the volatility of the marketplace, assumptions about future interest rate levels and the projected dividend yield of the index. The second component relates to the call option sensitivities. This component determines the price of the option and encompasses the same three parts: interest rates, volatility and dividend yield component of the valuation input. Valuation methodologies must be consistent throughout; otherwise, the potential for asset-to-liability matching will be skewed. Mismatch may result in distortion of profits or risk potential for the product.

Options can be valued utilizing either a market value approach or an amortized cost or prevailing book method approach. Whichever valuation of the option is used, it is important that insurers value the assets purchased to cover the option under a consistent method with the liabilities imposed by the product design of the option.

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<sup>7</sup>NFC Consulting Group, Spring 1997

## *RESERVING METHODOLOGIES*

The American Academy of Actuaries Equity Indexed Products Task Force initially recommended six interpretations of CARVM to be used for equity indexed annuities. In the fall of 1997, the recommended reserving methodologies for equity-indexed annuities were narrowed to three: CARVM with Updated Market Values (CARVM-UMV), Market Value Reserve Method (MVRM), and Enhanced Discounted Intrinsic Value Method (EDIM). See the December 6, 1997 Report of the Equity Indexed Product Task Force for more detailed information on the Academy's reserve methodology approaches. This report set out the following strengths and weaknesses of the recommended reserving methods:

### CARVM with Updated Market Values (CARVM-UMV):

1. The inclusion of the market value of the call option in the reserve reflects market realities on the balance sheet.
2. The method is robust in the sense that it can be applied to all known product designs.
3. The soundness of the method is independent of the hedging strategy.
4. The method is very complex and can not be easily integrated into current valuation systems.
5. The market value of the call option is heavily dependent on the option valuation assumptions.
6. CARVM-UMV may be used with both equity indexed deferred annuities and payout annuities.

### Market Value Reserve Method (MVRM):

1. The inclusion of the market value of the call option in the reserve reflects market realities on the balance sheet.
2. The method is robust in the sense that it can be applied to all known product designs.
3. The soundness of the method is independent of the hedging strategy.
4. The method is understandable and relatively easy to employ for deferred annuities. The method is easier to fit into current valuation systems than CARVM-UMV. However, there may be more effort required to gain regulatory approval for using MVRM as compared to MVRM [sic].
5. The market value of the call option is heavily dependent on the option valuation assumptions.
6. The method does not reflect the term structure of index return volatility or of interest rates. For some product designs, this is a weakness of MVRM. On the other hand, it avoids problems such as that mentioned in 6, above.
7. MVRM may be used with both equity indexed deferred annuities and payout annuities.

### Enhanced Discounted Intrinsic Value Method (EDIM):

1. This method does not reflect market realities on the balance sheet in the same way that the other two methods do.
2. This method is not appropriate for all product designs. It works well for products where the index credits are locked-in at intermediate points (e.g. cliquet and high water mark designs). It loses some of its strength when used for products where amounts that are in the money can later be lost due to market drops (e.g. point-to-point and Asian designs). EDIM is not appropriate for products that are expected to have significant interim benefits.
3. The method is easy to employ and can be fit easily into current valuation systems.
4. EDIM is applicable only to equity indexed deferred annuities, and not to equity indexed payout annuities.

## *INSURER PROTECTION AGAINST RISING INDEXES AND CONSUMER PROTECTION IN FALLING MARKETS*

Caps are designed to give insurers the ability to limit their exposure as the index rises. Floors are designed to provide protection to the consumer as the index falls. In 1996, many insurers introduced floors and caps into their products. Caps reduce the price of the EIA, making the product more affordable and easier to hedge, although they also limit the upside to the policyholder. Floors, in contrast, protect the consumer in the event the market falls as they shift the investment risk to the insurer. Hedging requires special attention because of the unique relationship between the stock market and interest rates, which do not necessarily tend to move in a synchronized manner. If the stock market continues to grow in 1998 as it did in previous years, caps structured into EIAs will protect the investment decisions of the insurers.

### *INSURER EXPENSES ASSOCIATED WITH EIAs*

Insurers incur expenses with EIAs that are similar to their expenses with other annuities. Typically, agent commissions on EIAs are comparable to commissions on other annuity products. Administrative expenses are higher for EIAs than for other annuity products due to the fact that company investment departments or outside investment managers must create special portfolios or acquire specialized investment products to effectively hedge the EIA. EIAs require additional monitoring and correction of the hedging strategy. Insurers also need to consider items such as whether the new product is self reliant and managed separately, whether the product is leveraging off of existing products in the insurer's portfolio, maintenance costs related to the size of the anticipated block of business, overhead allocations, costs associated with location of the office and the degree of technology. Of course, none of these considerations are unique to EIAs—they arise in connection with any new product.

### *CONSUMER EIA COSTS/TERMINATION CHARGES*

Consumers purchasing EIAs incur the typical costs of an annuity, plus the additional costs paid to insurers to manage the more complex investment issues associated with an indexed product. Surrender charges reflect the partial recovery of issue expenses and the liquidity costs to the insurer associated with the surrender of the contract. These charges are similar to those associated with most other annuity products and encourage consumers to recognize that EIAs are intended to be long-term contracts, and therefore are not suitable, either to the consumer or to the insurance industry, for early liquidation.

### *GUARANTY FUNDS*

The state guaranty funds through their national organization have sought to identify whether EIAs are covered under the NAIC Life and Health Insurance Guaranty Association Model Act (the "Guaranty Act"). This model law says at Section 3(B)1 that guaranty associations will pay for annuity contracts, subject to the limitations of Section 3(C)(2)(a)(i). The model law continues by stating at Section 3(B)(2) that guaranty associations will not pay for any portion of the contract which is not guaranteed by the contract. If the interest amount calculated on the basis of an equity index is guaranteed by the insurer, then the equity index benefit should be covered by the state generated funds, subject to the applicable limits.

The Report of the Equity Indexed Products Task Force, dated December 6, 1997, addressed the issue of how equity indexed annuities and life insurance could be treated for assessment purposes under the Guaranty Act. They responded that Class B assessments with respect to annuities and life insurance are based on premiums received by a company for contracts covered by the life insurance and annuity account. That account consists of three subaccounts:

- (1) a life insurance account
- (2) an annuity account which shall include annuity contracts owned by a governmental retirement plan (or its trustee) established under Section 401, 403(b) or 437 of the United States Internal Revenue Code, but shall otherwise exclude unallocated annuities
- (3) an unallocated annuity account, which shall exclude contracts owned by a governmental retirement benefit plan (or its trustee) established under Section 401, 403(b) or 457 of the United States Internal Revenue Code.<sup>8</sup>

The Guaranty Act makes no distinction between policies and contracts with equity indexed features and those without. A life insurance policy or allocated annuity with equity indexed features would be treated as any other life insurance policy or allocated annuity contract. Thus, premiums received on such contracts would be subject to assessment regardless of coverage limitations.

### *RISK BASED CAPITAL*

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<sup>8</sup>Underlining indicates language that is expected to be added to the Guaranty Act in the near future. The amendments are intended to clarify the original intent of the current wording in the Guaranty Act.

Companies have a host of considerations with respect to EIAs and risk based capital (“RBC”). The following chart lays out the NAIC RBC formula. Most companies are establishing RBC for EIPs using the risk factors identified below. The American Academy of Actuaries subgroup on EIPs continues to study the RBC issues associated with these products to determine if changes to the existing formats are necessary. At the present time, its recommendations regarding calculation of 1998 RBC are as follows:

- (1) The risk of hedge mismatch with the index will be considered part of the C3 (interest rate) component. Additional narrative to the RBC Instructions is proposed to make explicit that equity indexed products are included in the C3 component.
- (2) The C3 factors will be the same for equity indexed as for their non-indexed counterparts, at least for 1998 RBC.
- (3) No other changes to the RBC rules are needed for equity indexed products.

Current formats are:

|                 |  |
|-----------------|--|
| <b>C-1 Risk</b> | Varies by invested assets<br>5% factor for options, currently under review<br>30% for index funds<br>0% for swap   |
| <b>C-2 Risk</b> | Varies based on net amount at risk<br>Not applicable for EIAs<br>No additional components associated with EILs   |
| <b>C-3 Risk</b> | Same percentages as for fixed products<br>- 1-2% for EIAs depending on surrender charge<br>- .5% for EILs  |
| <b>C-4 Risk</b> | Based on insurance premiums<br>2% for life and annuity considerations<br>0% for fund deposits<br>Companies may reflect additional component for internal targets due to uncertainty associated with equity indexed products including rating agency reaction |

#### *RATING ORGANIZATIONS*

The most prominent of the insurance rating organizations, the A.M. Best Company, has indicated that it will look at equity indexed products and their design in the context of insurer ratings. In a recent release, Dick Vializ, Senior Financial Analyst from A.M. Best Life and Health Division, says that their “analysts want to know what the company's reasons were for offering an equity indexed annuity. Such a product can add to the strength of a company if it is strategically positioned within the insurer's already broadened array of asset accumulation products and meets specific needs and performances of a clientele.”

Mr. Vializ also went on to say that the “equity indexed product will also improve a company's rating position if it leverages existing capabilities such as proprietary investment and money management and uses an efficient ‘operating platform’ to maintain economies of scale.” On the other hand, “red flags may fly if a company introduces an equity indexed annuity solely or primarily as an incentive to recruit and retrain distributors, to counter a decline in its fixed annuities in force or because it lacks a variable product platform. A.M. Best will also look unfavorably upon a company and its rating analysis if the insurer introduces an equity indexed product solely because it isn't able to align itself with a strategic partner and may need to be more competitive in order to offer nonproprietary variable fund options.”<sup>9</sup>

<sup>9</sup>Risks Lurk in Market for Equity Indexed Products, *Best Insurance News*, May 1, 1997.

### *IS THE EIP A SECURITY?*

Many individuals and regulators have questioned whether the current EIAs should be registered with the Securities and Exchange Commission. Insurers generally believe that EIAs are not securities because the policyholder has no option or selection opportunity in the index which is used to calculate the equity indexed amount or in the selection of funds which are purchased in order to cover the index option. Others argue that there is a guaranteed return component of at least the return of principal which affords the EIA a safe harbor under Rule 151 under the Securities Act of 1933, as amended (the "1933 Act"), and is therefore exempt from registration with the SEC pursuant to § 3(a)(8) of the 1933 Act. Further, EIAs meet the state non-forfeiture requirements for fixed products in the states where they are approved. The assets which are purchased by the insurer to fund the equity index option are held in the general account of the insurer and are not separate account items.

On August 20, 1997, the Securities and Exchange Commission issued Concept Release No. 33-7438, File No. S7-22-97. The SEC's release provides an analysis of the applicability of federal securities laws to EIPs. The industry's comments concerning the structure and marketing of equity indexed products were due November 20, 1997, subject to an extension of time. The NAIC has responded to the SEC stating that the regulation of this insurance product is the province of the states. However, several states responded to the SEC stating that they believe the SEC should regulate these products instead of the states.

### *COMPANY TAX ISSUES*

There are several different tax strategies currently under consideration for calculating tax reserves. The first method establishes that tax reserves equal statutory reserves except that the valuation rate is AFR. The second method is to calculate the tax reserves utilizing the same method which the company uses to calculate its statutory reserves. The third method is to calculate the tax reserves on the cash value of the policies only. Although some companies have approached the Internal Revenue Service seeking guidance on particular EIA tax issues, the Service has yet to respond. Most companies follow a CARVM-type approach, but there is no established EIA tax reserve policy at the present time. However, in Internal Revenue Bulletin 97 TNT 90-7, the Service invited comments related to the interest rates to be used for the tax reserve valuation of equity indexed contracts which meet the requirements of Section 817A relating to modified guaranteed contracts.

### *GAAP RESERVES*

Insurers generally consider EIAs to be fund based products and use FAS 97. Conservatism may call for an additional reserve on the equity indexed portion. Inclusion of the asset basis also needs to be calculated when establishing the GAAP reserves as well as DAC amortization.

### *HEDGING*

Hedging is a method for providing an appropriate amount of value at a future date by transferring the risk of unfavorable price fluctuations through the purchase and sale of options and futures contracts. A company must determine which type of hedge is appropriate for its EIA product design and its own portfolio strategy. When making a decision on hedging strategy, product modeling is required.

For years, traditional insurance product designs have sought to manage the disintermediation risk--the risk that policyholders will surrender their contracts, potentially forcing the company to sell assets at a loss to meet cash flow demands. The risk exists because policyholders tend to surrender in order to move money to new products when interest rates have gone up. These higher interest rates typically also mean that an insurance company's fixed income assets have gone down in value, creating a scenario for potential capital losses from asset sales.

With EIAs, disintermediation risk takes on a new dimension because the stock market and interest rates can move either together or in different directions. This lack of synchronization presents the company with different risks for policyholder surrenders. This is a crucial part of the hedging strategy. Of the four possible scenarios, one scenario is especially important because historically an increase in interest rates generally is accompanied by a decrease in the stock market. This results in two incentives for policyholders to surrender. It also creates two potential sources of capital losses on assets (bonds and options). The incentive for surrenders and potential capital losses are less for

the other three scenarios (interest rates up with the stock market up, interest rates down with the stock market up, and interest rates down with the stock market down).

It is the job of the insurer to quantify the disintermediation risk in these scenarios. To quantify the disintermediation risk, the insurer must calculate the expected return on capital, test the expected return by variances and determine the coefficient interval to measure the variance of return on capital. Product design typically plays an important role in managing disintermediation risk. This risk is generally considered by insurers when structuring EIAs.

### *PRICING CONSIDERATIONS*

In addition to the typical cost/revenue items, insurers consider the following when pricing their EIAs:

- ! The percentage of business which can be expected to continue beyond the initial term.
- ! The consequences of rollovers.
- ! The level of commissions paid to sell the product.
- ! The type of distribution channel used and the cost associated with that distribution channel.
- ! Both critical components of the lapse rates scenario being valued--during the early portion of the contract, as well as during later periods.
- ! Depending on the EIA product design, the option price can frequently cost from 5% to over 15% of the premium.

### *MARKETING MATERIAL AND DISCLOSURE*

Part of the charge set forth to the American Academy of Actuaries was to examine marketing material and disclosure needs for equity indexed products. The following guidelines were recommended to regulators in developing new model regulations and modifying existing model regulations to address these issues.

#### 1. Proposal for Recommended Guidelines to Regulators for Marketing Materials Used in the Sale of Equity Indexed Annuity Products

For purposes of these Guidelines, it is recommended that the definition of “Non-guaranteed policy elements” in the Rules Governing the Advertising of Life Insurance be modified to include consideration of the Equity Index.

##### A. Goals/Objectives:

1. Foster consumer education and understanding of equity indexed products
2. Provide consumers with clear information about these products
3. Be consistent with NAIC Model Rules Governing the Advertising of Life Insurance (including annuity products) whose purpose is:

To set forth minimum standards and guidelines to assure a full and truthful disclosure to the public of all material and relevant information in the advertising of life insurance policies and annuity contracts

##### B. Definitions:

1. “Invitation to inquire” is defined for these recommended guidelines as marketing material whose objective is to create a desire to learn more about the product and is limited to a brief description
2. “Invitation to contract” is defined for these recommended guidelines as marketing material that is not an invitation to inquire

##### C. Marketing Material:

1. It is recommended that any marketing material used which is an invitation to inquire or an invitation to contract consumers in the sale of equity indexed products be covered by the NAIC Model Rules Governing the Advertising of Life Insurance. These rules require that advertising material must:

- a. be truthful and not misleading in fact or by implication
- b. be sufficiently complete and clear so as to avoid deception
- c. not have the capacity or tendency to mislead or deceive

Compliance of advertising material with the Rules is measured based on the overall impression

D. Balancing Language:

1. It is recommended that any marketing material which is an invitation to contract and contains language regarding the non-guaranteed elements, provide consumers with a balanced view of the policy provisions inherent in the equity indexed design
2. The purpose of balancing language is to ensure that both the negatives and positives of product features are described for consumers. Appendix A (recited below) offers some examples of balancing language. These examples are in no way an all-inclusive list of balancing language nor must the specific words be used.

2. Proposal for Recommended Guidelines to Regulators for Disclosures Used in the Sale of Equity Indexed Annuity Products

It is recommended that the Guidelines to Regulators for Marketing Materials also be applicable to disclosures

A. Goals/Objectives:

1. Foster consumer education and understanding of equity indexed annuities
2. Provide consumers with a clear explanation of how these products operate
3. Set appropriate expectations on how these products function
4. Be as neutral as possible with regard to policy design
5. Be consistent with the proposed NAIC Annuity Disclosure Model Regulation (As revised at the April 30, 1997 Interim Meeting of the NAIC Life Disclosure Working Group) and the NAIC Model Rules Governing the Advertising of Life Insurance (including annuity products)
6. Be complementary to work done on equity indexed nonforfeiture and policy design
7. Provide consumers with a balanced view of the advantages and disadvantages of the indexed policy provisions

B. Disclosure of Guaranteed Benefits and Values, Including Guarantees within the Non-Guaranteed Equity Indexed Design:

1. Disclosure of all fully guaranteed benefits and values and all guaranteed parameters related to the non-guaranteed equity indexed design is required by the proposed NAIC Annuity Disclosure Model Regulation (As revised at the April 30, 1997 Interim Meeting of the NAIC Life Disclosure Working Group). This proposed Model Regulation applies to most group and individual annuity contracts and certificates including equity indexed annuities. It requires that applicants be given a disclosure document which has numerous disclosures about the annuity contract including the requirement of a description of :
  - a. the guaranteed and non-guaranteed elements of the contract, and their limitations, if any, and an explanation of how they operate

C. Disclosure of Total Amounts of Non-Guaranteed Elements of the Equity Indexed Design:

1. It is recommended that disclosure of total amounts of non-guaranteed elements of the equity indexed design be optional. It is further recommended that if shown: it may be narrative or tabular, under single or multiple scenario(s) (e.g., historical, hypothetical, level, fluctuating) and under any index; the disclosure may be shown generically or may be personalized to the applicant as long as it is fully identified as to which method is used; and any projection period used must be such that the implications of going beyond the initial term of the product design are clearly disclosed to consumers.

2. Many options for disclosing values to consumers were reviewed including: narrative versus tabular, single versus multiple scenarios, historical versus hypothetical, indices that were level versus fluctuating, and generic versus personalized. Every option had desired features as well as drawbacks. Given the variety of today's and future equity indexed product designs and the number of different components that have to be considered, it was concluded that no one option can adequately capture the policy mechanics of all equity indexed product design variations. Therefore, it is recommended that all such options be permitted, but must be supplemented by balancing language. This supports the needed flexibility in presenting total amounts of non-guaranteed elements in equity indexed designs and also ensures consumers have full and balanced information for their decision making process.

D. Balancing Language:

1. It is recommended that any disclosures containing language regarding the non-guaranteed elements provide consumers with a balanced view of the policy provisions inherent in the equity indexed design.
  2. The purpose of balancing language is to ensure that both the negatives and positives of product features are described for consumers. Appendix A (recited below) offers some examples of balancing language. These examples are in no way an all-inclusive list of balancing language nor must the specific words be used.
3. Proposal for Recommended Guidelines to Regulators for Annual Reports for Equity Indexed Annuity Products
- A. It is recommended that annual reports to consumers of equity indexed annuities be required
  - B. It is recommended that such annual reports have to satisfy the NAIC Model Rules Governing the Advertising of Life Insurance
  - C. It is further recommended that such annual reports, at a minimum, disclose the following values as of the annual report date:
    1. Cash Surrender Value
    2. Account Value
    3. Death Benefit
    4. Contributions for the year
    5. Outstanding loans, if any
    6. Anything specific to the equity indexed design that affected the values during the year

Appendix A to the December 6, 1997 Report of the Equity Indexed Products Task Force contains the following examples of balancing language:

1. To the extent that the index methodology uses averaging and it is advertised that protection is provided against downturns, it must also be disclosed that the method does not give full credit for an upturn.
2. To the extent that the index methodology is based on multiple factors, then it must also be disclosed that comparisons of a single factor can be misleading.
3. To the extent that any year to year index increases or volatility (hypothetical or historical) are disclosed, then it must also be disclosed that that performance is no indication as to future performance.
4. To the extent that the index excludes dividends, such a fact should be disclosed.
5. To the extent that early termination or the exercise of withdrawal rights may result in the loss of some or all of the benefit of any increases in the index, this must be disclosed.

6. To the extent that the marketing material includes statements like “participate in the upside of the Index” or “participate in the upside without risk” then it must also be disclosed that there is a downside risk which can go to the guaranteed minimum level.

As an additional aid to the consumer, the Equity Indexed Annuity Buyer’s Guide Subgroup of the Technical Resource Advisors to the NAIC Life Disclosure Working Group has developed a buyer’s guide which was adopted by the NAIC at the June 1998 meeting. This guide, now known as the Buyer’s Guide to Equity Indexed Annuities, is consumer-friendly and utilizes layman’s language in a question and answer format. The guide will eventually be modified to become an appendix to the Deferred Annuities Buyer’s Guide. Companies are asked to use the interim EIA Buyer’s Guide voluntarily until such time as a regulation and final Buyer’s Guide are adopted.

## **EQUITY INDEXED PRODUCTS – CONCLUSION**

EIPs offer the life insurance industry a potent retirement product design which will compete effectively with similar mutual funds and bank products. The life industry has one significant and unique advantage over other financial institution retirement products--the ability to guarantee the consumer’s principal investment. The life insurance industry will be able to compete in tomorrow’s retirement product marketplace if the industry and regulators expeditiously address the solvency and consumer protection issues inherent in the introduction of new product designs.

The generally positive experience of open and committed dialogue between the industry and regulators at the NAIC and at the American Academy of Actuaries gives hope that in the future, new product designs will be expeditiously analyzed and accepted by the regulators. This approach will allow the life industry to create and market new product designs competitively in the marketplace, thereby allowing the consumer the opportunity to purchase products which contain a guarantee feature.