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 participantinitiated 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

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

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

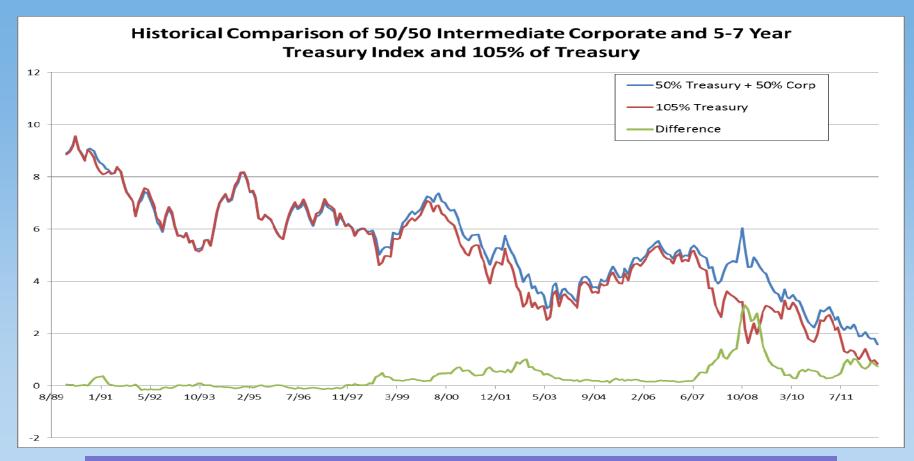
Selection of Corporate Bond Index

- 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

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

Historical Comparison of 50/50 Blend and 105% Treasury



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



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)

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

Questions?

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