AM Best assesses variable annuity regulatory reforms

By Editorial Staff *Thu, Jan 14, 2021*

The NAIC's VA reforms 'will serve to diminish the noneconomic volatility..., but ongoing developments related to the pandemic will likely lead to more uncertainty, with potential increases in equity market volatility,' the ratings agency said.

AM Best expects variable annuity (VA) reforms from the National Association of Insurance Commissioners' (NAIC) to diminish noneconomic volatility that resulted under the previous framework and may reduce the use of captives by US life insurance and annuity writers.

In its Best's Market Segment Report, "Variable Annuities Reforms Leading to Mixed Results for Life/Annuities Insurers," AM Best notes that the new rules eliminate a Standard Scenario Amount (SSA). The SSA was the primary cause of noneconomic volatility as it was a single-prescribed scenario, reflecting an immediate drop in equity prices, followed by low returns thereafter, and did not recognize hedging beyond the first valuation year.

In addition, policyholder behavior assumptions used to determine the SSA did not reflect more-recent industry experience. The VA reforms also change the accounting treatment for hedges, currently marked to market, to better match the liability being hedged.

The VA reforms were in effect as of Jan. 1, 2020, but companies had the option to adopt the changes earlier. Early adoption may have had some advantages, but one disadvantage was the loss of the option to grade in the changes over the next three years. Of the companies with larger exposures to VA business, four adopted VA reforms as of year-end 2019—Jackson National, Equitable, Transamerica, and Brighthouse—with mixed results.

Although the NAIC's changes will help fix various flaws in the existing framework, the potential for volatility will challenge VA writers. While increased hedging levels no longer will result in potential noneconomic volatility, the levels will still be driven by market conditions and the impact on the actual costs of such hedges.

Other financial solutions are still limited, given the decline in reinsurance activity. Moreover, the use of captive reinsurance is likely to decline significantly because of the recommended changes; however, as long as true economic values and those of various accounting regimes differ, the use of alternative financing methods will continue.

During the first quarter of 2020, companies with large exposures to VAs reported significant reserve increases due to market performance, leading to large declines in pretax operating income. Operating losses continued through the third-quarter 2020, albeit at lower levels than in the first quarter.

The challenges of the past year have put pressure on VA writers, and persistently low interest rates have made it more difficult to manage VA blocks of business. The VA reforms will serve to diminish the noneconomic volatility under the previous regime, but ongoing developments related to the pandemic will likely lead to more uncertainty, with potential increases in equity market volatility.