



Canadian Life  
and Health Insurance  
Association Inc.

# **Establishing Appropriate Reserve Requirements for Variable Annuities in Japan**

**Joint Proposal of the American Council of Life Insurers,  
the European Business Community, and  
the Canadian Life & Health Insurance Association Inc.**

**December 11, 2002**

## **1. Summary**

Current reserve requirements<sup>1</sup> for variable annuities in Japan require insurance companies to hold a larger share of premium reserves relative to account value than in other countries, which has the effect of making variable annuity products more costly than in other countries, both for insurance companies and for consumers.

In the short term, the American Council of Life Insurers (ACLI), the European Business Community (EBC) Insurance Committee and the Canadian Life and Health Insurance Association Inc. (CLHIA) recommend changes to the reserving methodology for variable annuity products in Japan to allow a method like the one used in the US (the so-called CARVM approach) for setting premium reserves for variable annuity products to provide relief for the strain on capital due to new business. At the same time, the ACLI, the EBC and the CLHIA recommend that the contingency reserving methodology recognize an explicit tax exempt standard reserve requirement for the risks inherent in guaranteeing the minimum death benefit and other popular guarantees included in variable annuity products.

Doing both things in tandem would benefit both insurance companies and consumers by reducing excess capital strain for premium reserves in the short run and ensuring adequate contingency reserves in the long run. It would also help promote the healthy growth of the variable annuity industry in Japan by providing consumers a more cost-effective tool for managing their retirement assets. In the longer term, the ACLI, the EBC and the CLHIA believe that the industry should consider a move toward contingency reserving methodology for variable annuity products based on stochastic calculations in line with recent international developments.

## **2. Regulatory Background**

A variable annuity is an insurance contract based on one or more investment trusts, managed by professional investment managers, with insurance features that allow

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<sup>1</sup> Reserve requirements are defined as the current amount that insurance companies must set aside in order to fulfill future policyholder and annuity obligations. In other words, it is the present value of the amount that will be necessary in the future.

investments to grow on a tax-deferred basis. It also provides investment protection in case of death and the option to receive an annuity income. Variable annuities are increasing in popularity in Japan due to strong demand for products that help individuals plan for retirement and guard against the risk of outliving their assets.

Variable annuities are more costly in Japan because current reserving methods require insurance companies in Japan hold a larger share of premium reserves relative to account value than in other countries, which increases the fees that insurance firms must charge their customers to meet goals for return-on-capital. The ACLI, the EBC and the CLHIA feel that Japanese reserving requirements for variable annuity products do not adequately take into consideration the unique characteristics of variable annuities, especially for single-premium types.

According to the Japanese Insurance Business Law's Enforcement Regulations, Article 69 (Underwriting Reserves for Life Insurance Companies), three types of underwriting reserves must be credited at each settlement of accounts:

1. Premium reserves (item 1, section 1);
2. Unearned premiums (item 1, section 2); and
3. Reserve for future contingencies (item 1, section 3).

Further, for insurance contracts that use special accounts, such as variable annuities, Article 69 (item 4, section 3) requires that the total balance of those special accounts be credited to the premium reserves with no exception.<sup>2</sup> This restriction was originally drafted as a measure to protect corporate pension funds managed by insurance companies, long before variable annuities were available in Japan.

However, this restriction ignores important differences among insurance products, such as fee structure and acquisition expenses, and requires a more conservative approach for premium reserves than is required for other insurance products. This regulation currently prevents insurers from taking surrender fees, acquisition costs and other product characteristics and risk parameters into account when calculating variable annuity premium reserves. Since insurance companies were permitted to sell variable annuities in April 1999, it has had the consequence of causing excess capital strain by forcing insurers in Japan to carry amounts of premium reserves in excess of prudent actuarial practices. This extra capital strain adds to the cost of variable annuities, especially for single-premium type products.<sup>3</sup>

### **3. Impact of Fee Structure on Premium Reserves**

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<sup>2</sup> Item 4, section 3 reads: "With respect to the premium reserve referred to in item (1) of the immediately preceding paragraph in connection with the insurance contracts for which a special account is established, the balance of the accounts in the said special account shall be credited to such reserve."

<sup>3</sup> Another reason variable annuities are more expensive in Japan is due to policy holder protection fund assessments. Policy holder guarantee fund assessments are not required for variable annuity contracts in the US because the assets are kept in separate accounts and are protected from creditors in case of bankruptcy. Policy holder protection fund assessments are required for variable annuities in Japan because the assets are kept in special accounts that are not protected from creditors in case of bankruptcy. In case of bankruptcy variable annuity policyholders in the U.S. can only look to their assets for coverage while in Japan they can expect the fund to guarantee 90% of their contract value.

Unlike most life insurance contracts that charge a one-time, up-front fee against the insurance premium amount, most variable annuities do not charge an up-front fee and instead charge an annual expense and mortality fee as a percentage of the account balance each year. This annual fee is charged on a daily basis at 1/365 of the annual rate. Most customers prefer paying an annual fee rather than a one-time, up-front fee, because the annual fee structure allows more of the initial principal amount to be invested in the investment trust(s) specified by the policy holder.

However, if the contract holder cancels soon after the policy is issued, the use of an annual fee instead of a one-time, up-front sales fee makes it difficult for the insurer to recover sales expenses incurred when the variable annuity contract was originally issued. To make up for the risk of early cancellation and ensure recovery of customer acquisition costs, insurers charge a back-end surrender fee to contract holders who cancel during a specified period of time. Surrender fees typically average 6% - 8% for the first year and decline incrementally over a period of 5 to 10 years, after which no surrender fee is charged.

Due to Article 69, differences in product fee structures can have a large impact on the amount of premium reserves required if reserves are based on the net premiums applied, particularly for single-premium variable annuities. If contract holders are charged a one-time, up-front fee against insurance premiums paid, then the initial amount of premium reserves required would be equal to the premium paid in, minus the amount of the up-front sales fees collected. On the other hand, if contract holders are charged fees on a daily basis spread out over multiple years, then the initial amount of premium reserves required would be equal to the total premium paid in. As a result, although the initial gross premium is the same in both cases, much higher premium reserves would be required for products that use an annual fee structure than for products that use an up-front sales fee structure.

Based on the understanding that reserves should be set aside sufficient to fulfill future policyholder obligations, premium reserves do not need to be equal to the total special account value (insurance premiums minus fees plus investment returns) during the period of time during which surrender fees are applicable. The reason is that for insurance contracts that use a surrender fee, such as variable annuities, the total special account value is greater than the maximum amount that would ever have to be paid to contract holders at any one time. This is because the value of the surrender fees is not part of the maximum payment available to contract holders in case of surrender.

#### **4. Contingency Reserves**

At the same time, the ACLI, the EBC and the CLHIA are concerned that in the long term variable annuity contingency reserve requirements in Japan will not accurately reflect the need to account for underlying economic risks associated with popular variable annuity benefits, such as the guaranteed minimum death benefits. A revision of the variable annuity contingency reserve actuarial practices would protect policyholders by ensuring adequate reserves for the long term.

## 5. Proposals

In order to alleviate capital strain for premium reserves in the short run while at the same time ensuring adequate contingency reserves for death benefit guarantees in the long-run, the ACLI, the EBC and the CLHIA recommend reserving methodology for premium and contingency reserves be changed in Japan to accurately reflect the unique characteristics of variable annuity products. Two changes are proposed, which should be implemented in conjunction:

1. The ACLI, the EBC and the CLHIA ask that the Financial Services Agency permit alternative methods for calculating variable annuity premium reserves that take into account surrender fees, acquisition costs and other product characteristics and risk parameters. Japanese regulators have approved a variety of alternative actuarially-sound reserving methods for other types of insurance products, and we ask for similar treatment for variable annuities. This would likely require changes to the Insurance Business Law to eliminate the requirement that total special account value be credited to premium reserves for variable annuities. These changes would reduce unnecessary surplus strain by allowing a slight reduction of premium reserves below the total special account value, as in the US, Canada and the European Union. The changes would also bring premium reserve requirements for variable annuities in line with premium reserve requirements for other insurance products in Japan.

It is important to note that even if lower premium reserve requirements were allowed for variable annuities in Japan, the special accounts for variable annuities would continue to be fully funded. The difference between the account value in the special accounts and the premium reserve would become either a surplus or part of the reserves that cover general account liabilities and thus indirectly create surplus. Although this surplus would not be included in the calculation of the variable annuity premium reserves, it would continue to be held in the special accounts.

2. At the same time, the ACLI, the EBC and the CLHIA recommend that reserving methodology recognize an explicit tax-exempt standard contingency reserve requirement for the risks inherent in guaranteeing the minimum death benefit in order to protect consumer interests. This would ensure that solvency requirements match underlying economic risks and also promote the development of a level playing field in the Japanese market.

Doing these two things would ultimately benefit consumers because over the long-term life insurance companies could either lower fees or offer additional product features and still expect a reasonable return on capital while maintaining adequate reserves. It would also help promote the healthy growth of the variable annuity industry in Japan by providing consumers a more cost-effective tool for managing their retirement assets. However, the actual timing and amount of mortality and expense fee reductions or additional product features that would be possible if reforms were implemented would vary widely from insurer to insurer, depending on characteristics such as the pricing structure and benefit profile of their variable annuity products.

## 6. Suggested Methodologies

In the short term, the ACLI, the EBC and the CLHIA feel that these goals would be best accomplished by adopting a strategy similar to the Commissioners' Annuities Reserve Valuation Method (CARVM) currently used in the US. In the United States, insurance regulators require insurers to take differences in fee structure and other product and risk parameters into account when calculating reserves for annuities. More than 25 years ago, the National Association of Insurance Commissioners (NAIC) adopted the Commissioners' Annuities Reserve Valuation Method (CARVM) for fixed and variable annuities and the Commissioners' Reserve Valuation Method (CRVM) for other life insurance products. The NAIC guidelines on CARVM and CRVM have been approved for use in all 50 states in the United States.

CARVM defines the minimum reserves for annuities as "the greatest possible present value of all future guaranteed benefits" and requires many product and risk parameters to be taken into account when calculating reserves according to accepted actuarial practices. Product parameters include things like surrender fees, policy fees and other expense charges, guaranteed withdrawal benefits and guaranteed death benefits. Risk parameters include things like guaranteed interest rates, investment performance, asset allocation, and the risk of a sudden drop in assets. Of these many parameters, surrender fees usually have the single-largest impact on the calculations of reserves because U.S. insurers are not required to hold the value of fees that would be charged in case the contract holder surrenders. Based on U.S. experience, one can estimate that insurers in Japan are required to maintain premium reserves for single-premium variable annuities that are excessive by approximately the amount of surrender fees that would be charged.

It should be noted that CARVM is considered a conservative standard because it requires insurers to set aside reserves for the worst possible scenario. One reason surrender fees are recognized in CARVM is that a key principle in the definition of minimum reserve methodology stipulated in the U.S. Standard Valuation Law and related regulations provides an allowance for recognition of customer acquisition expenses incurred in the sales process (i.e., the commission paid to distributors). Surrender fees on annuity contracts allow the insurer to recover part of the expense of commissions paid when the policy was issued, if the policy is cancelled within a certain period of time. It is important to note that a CARVM reserve is consistent with a reserve based on net premiums and traditional reserving methods. Both types of reserves are the present value of future benefits minus the present value of future premiums (which are zero for single premium products).

In the long term, the ACLI, the EBC and the CLHIA feel that Japan should consider adopting stochastic approaches, such as those being used in Canada and the UK, in reserving methodology for variable annuities. While stochastic methodologies are admittedly more complex than traditional deterministic approaches, they do have the distinct advantage of better reflecting the risks inherent in a variable annuity's guaranteed death benefit, which varies depending on the performance of the underlying investment trust. Canadian regulators expect insurers with material guaranteed minimum death or maturity benefits to employ stochastic methods in calculating reserves for these guarantees. Regulators in the UK have required stochastic methods to be applied to investment guarantees for unit-linked (variable)

policies for over 20 years, and are now considering expanding this approach to other guarantees in the near future. A move towards a more stochastic approach is also the trend in the US and in the European Union, and Japanese life insurance companies as well, have started to use such methodologies to determine prices for the products that they intend to sell.

**About the American Council of Life Insurers (ACLI)**

The American Council of Life Insurers (ACLI) is the largest insurance association in the United States of America with 390 life insurance companies as members and a staff of almost 200. ACLI's members are the leading providers of financial and retirement security products covering individuals and business markets and account for the overwhelming majority of the life insurance premiums and annuity considerations in the United States. The ACLI represents legal reserve life insurance companies and fraternal benefit companies operating in the United States before federal and state policymakers, insurance departments, and the courts. Additional information is available at [www.acli.org](http://www.acli.org).

**About the European Business Community (EBC)**

The EBC is the trade policy arm of the 13 European National Chambers of Commerce and business associations in Japan. First established in 1972, the EBC works to improve the trade and investment environment for European companies in Japan. The EBC currently represents more than 3,000 local European companies and individuals who are members of their national chambers of commerce. Around 360 of the companies participate directly in the EBC's 27 industry committees and subcommittees, whose work aims to improve the local business environment in a wide variety of industry sectors. Additional information is available at [www.ebc-jp.com](http://www.ebc-jp.com).

**About the Canadian Life & Health Insurance Association Inc. (CLHIA)**

The Canadian Life & Health Insurance Association Inc. (CLHIA), established in 1894, represents 72 life and health insurance companies, which together account for about 97 per cent of the life and health insurance in force in Canada, and administer about two-thirds of the pension plans in the country. Canadian life and health insurers receive over 55 per cent of their worldwide premiums from outside Canada. Additional information is available at [www.clhia.ca](http://www.clhia.ca).