Title:	Embedded Derivatives: Deferred Variable Annuity Contracts with Payment Alternatives at the End of the Accumulation Period
Paragraph references:	6(c), 9, 10(c), 12, 57(c), 200
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QUESTIONS

There are various types of annuity payment options offered by insurance enterprises to policyholders. This Issue addresses four common payment alternatives. The first three questions address the accounting for payment alternatives offered during the accumulation phase of the contract, while the fourth question addresses the accounting for guaranteed minimum periodic annuity payments in the contract's payout phase.

1. During the accumulation phase of a deferred variable annuity contract, would the guarantee of a minimum interest rate to be used in computing periodic annuity payments if and when a policyholder elects to annuitize require separate accounting as an embedded derivative under paragraph 12 of Statement 133?
2. During the accumulation phase of a deferred variable annuity contract, would a provision that guarantees a minimum account value that is available to annuitize if and when a policyholder elects to annuitize require separate accounting as an embedded derivative under paragraph 12 of Statement 133?
3. During the accumulation phase of a deferred variable annuity contract, would a provision that guarantees a minimum level of periodic annuity payments during the payout phase if and when a policyholder elects to annuitize into a variable-payout annuity require separate accounting as an embedded derivative under paragraph 12 of Statement 133? This question assumes that the contract is annuitized at its contract value without any floor account value guarantee specified in Question 2.
4. During the payout phase of a variable-payout annuity, would a provision that guarantees a minimum level of periodic payments require separate accounting as an embedded derivative under paragraph 12 of Statement 133? (This type of provision may be found in contracts referred to as standalone immediate-payout annuities or in the payout phase of an existing annuity.)

BACKGROUND

Paragraph 12 of Statement 133 states, in part:

> An embedded derivative instrument shall be separated from the host contract and accounted for as a derivative instrument pursuant to this Statement if and only if all of the following criteria are met:
>
> a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract. Additional guidance on applying this criterion to various contracts containing embedded derivative instruments is included in Appendix A of this Statement.
> b. The contract ("the hybrid instrument") that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.
> c. A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11, be a derivative instrument subject to the requirements of this Statement. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

An annuity contract, as defined in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, is a contract that provides fixed or variable periodic payments made from a stated or contingent date and continuing for a specified period, such as for a number of years or for life. A variable annuity contract is defined in Statement 60 as follows:

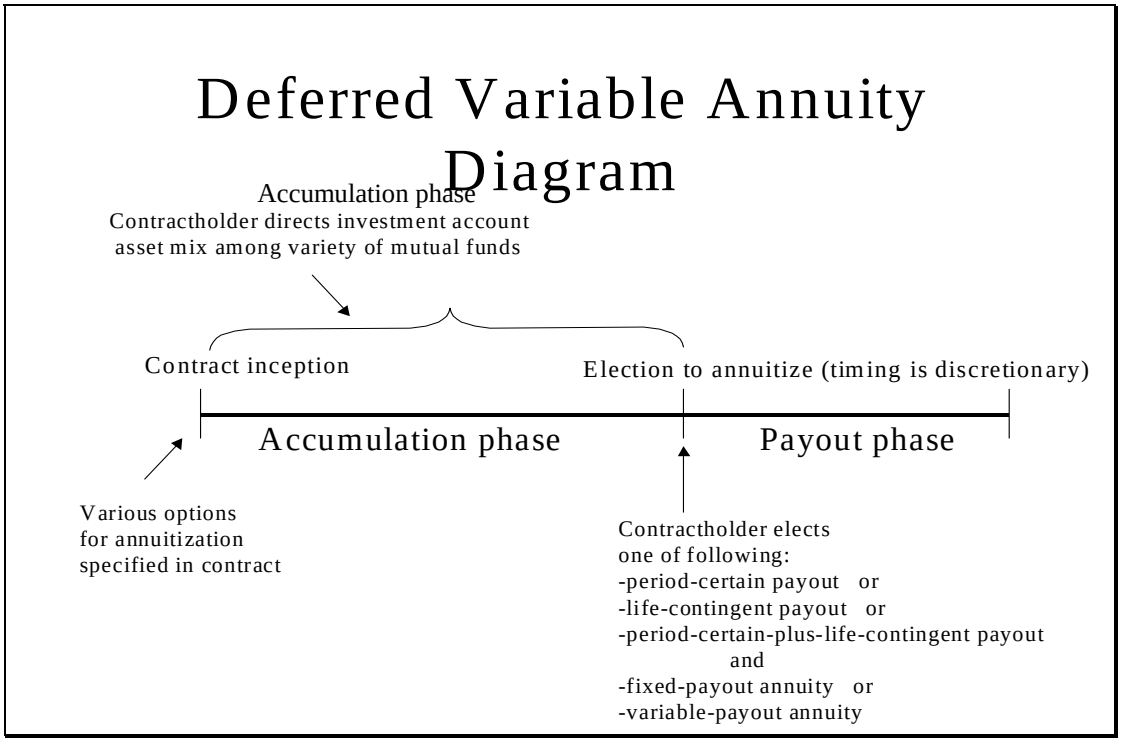
> An annuity in which the amount of payments to be made are specified in units, rather than in dollars. When payment is due, the amount is determined based on the value of the investments in the annuity fund.

An annuity contract for which payments have not yet commenced is referred to as a deferred annuity. Deferred annuities may be considered in two separate phases. The first phase is the deferred or accumulation phase, during which payments received by the insurance enterprise are accumulated and earn either a fixed or variable return. Much like a savings account, the cash surrender value may be withdrawn. The second phase is the payout phase, during which annuity income payments are made to the annuitant. For the payout phase of an annuity, annuity income payments are made to the annuitant under one of various options chosen by the policyholder upon annuitization, including the following:

- Life-contingent payments (payable for life of the annuitant)
- Payments for a period certain (for example, a 10-year period-certain annuity would be paid for 10 years to the annuitant or the annuitant's beneficiary or estate)
- Period-certain-plus-life-contingent payments (for example, a life-and-10-year-certain annuity pays the annuity benefit for the greater of the annuitant's life or 10 years).

Historically, contracts have typically been structured such that once the payout phase has begun, there is no longer a cash surrender value. However, more recently, some insurance companies have begun offering contracts with withdrawal features that allow withdrawals of all or a portion of the present value of a policyholder's future contractual annuity payments within a specified period during the payout phase. Upon surrender, additional withdrawal charges to cover investment costs may or may not be imposed.

The following diagram illustrates an overview of a deferred variable annuity contract:



Paragraph 7 of FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* provides that the accumulation phase and the payout phase of a deferred annuity contract are typically treated as if they were two separate contracts. That is, Statement 97 notes the following:

> A contract provision that allows the holder of a long-duration contract to purchase an annuity at a guaranteed price on settlement of the contract does not entail a mortality risk until the right to purchase is executed. If purchased, the annuity is a new contract to be evaluated on its own terms.

Fixed or variable annuity contracts in the accumulation phase and period-certain annuities in the payout phase are typically considered investment contracts under Statement 97 given that they typically lack significant mortality risk. Fixed or variable annuities in the payout phase that

provide for life-contingent payments are typically accounted for as insurance contracts given that they contain significant mortality risk. Payout phase period-certain-plus-life-contingent annuities are accounted for as insurance contracts under Statement 97 unless (a) the probability that life-contingent payments will be made is remote or (b) the present value of the expected life-contingent payments relative to the present value of all expected payments under the contract is insignificant.

Paragraph 10(c) notes that, generally, contracts of the type that are within the scope of Statement 60, Statement 97, and FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, are not subject to the requirements of Statement 133. Paragraph 7 of Statement 97 indicates that mortality risk is present if, under the terms of an annuity contract, the enterprise is required to make payments contingent upon the continued survival of a specific individual or group of individuals.

Paragraph 200 discusses the application of Statement 133 to "traditional" variable annuity product structures, as contemplated in Statement 60 and Statement 97, and states that they are generally not subject to the scope of this Statement, except for payment options at the end of the accumulation period. According to paragraph 200, payment alternatives are options subject to the requirements of this Statement if interest rates or other underlying variables affect the value.

A policyholder can also elect an immediate payment of the account value during or at the end of the accumulation period. Any sort of minimum guarantee offered in conjunction with a variable annuity that is provided *prior to* annuitization would be covered by Statement 133 Implementation Issue No. B8, "Identification of the Host Contract in a Nontraditional Variable Annuity Contract," rather than by this Issue.

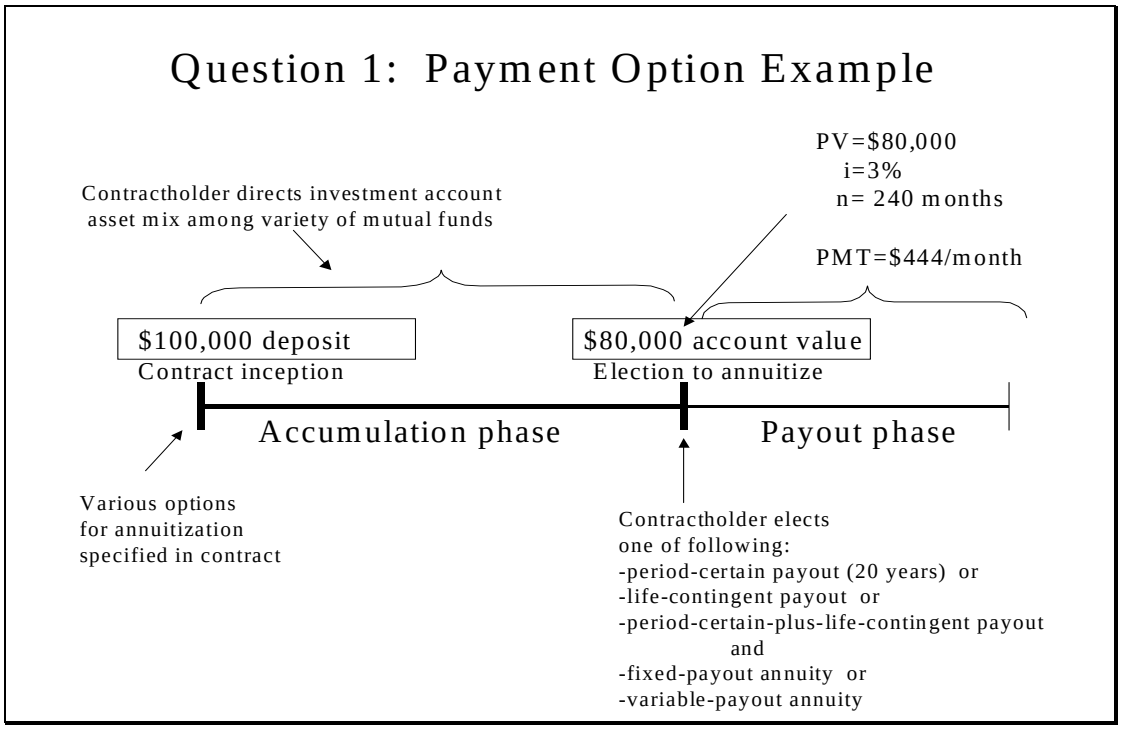
Background Information Applicable to Question 1

A common feature in most, if not all, deferred variable annuities is the option to annuitize at a guaranteed minimum annuity interest rate. That is, at the date of annuitization, the fixed periodic annuity payments would be determined using whatever current accumulated account value existed at the date of annuitization and the higher of the minimum guaranteed interest rate and currently offered annuity interest rates. For life contingent annuities, a mortality table would also be specified. The following narrative provides an example of this rate guarantee.

Question 1 Example: The policyholder deposits $100,000 in a deferred variable annuity that provides for a guaranteed minimum interest rate of 3 percent in computing future periodic annuity payments if the policyholder chooses to annuitize at a future date. The policyholder directs his deposit to equity-based mutual funds within the separate account. At the date that the policyholder chooses to annuitize, his account value has declined to $80,000 due to stock market declines. He elects a 20-year period-certain fixed-payout annuity, payable monthly in arrears. Using the $80,000 account value at the date of annuitization and the 3 percent interest rate (which is above the currently offered annuity interest rate), the insurance company calculates his

monthly periodic annuity payments to be $444. Because a fixed-payout annuity is elected, the $444 monthly annuity payment would be fixed throughout the entire payout period.

The following diagram illustrates the payment option discussed in Question 1:



Question 1 (Repeated from Above)

During the accumulation phase of a deferred variable annuity contract, would the guarantee of a minimum interest rate to be used in computing periodic annuity payments if and when a policyholder elects to annuitize require separate accounting as an embedded derivative under paragraph 12 of Statement 133?

RESPONSE TO QUESTION 1

No, during the accumulation phase of a deferred annuity contract, the guarantee of a minimum interest rate to be used in computing periodic annuity payments if and when a policyholder elects to annuitize does not require separate accounting under paragraph 12, because the criterion in paragraph 12(c) is not met. The embedded option does not meet the definition of a derivative instrument because it does not meet the net settlement criteria in paragraph 6(c) and paragraph 9. Settlement of the option can be achieved only by an investment of the account balance in a payout annuity contract in lieu of electing an immediate payment of the account value. (Refer to Statement 133 Implementation Issue No. A13, "Whether Settlement Provisions That Require a Structured Payout Constitute Net Settlement under Paragraph 9(a).")

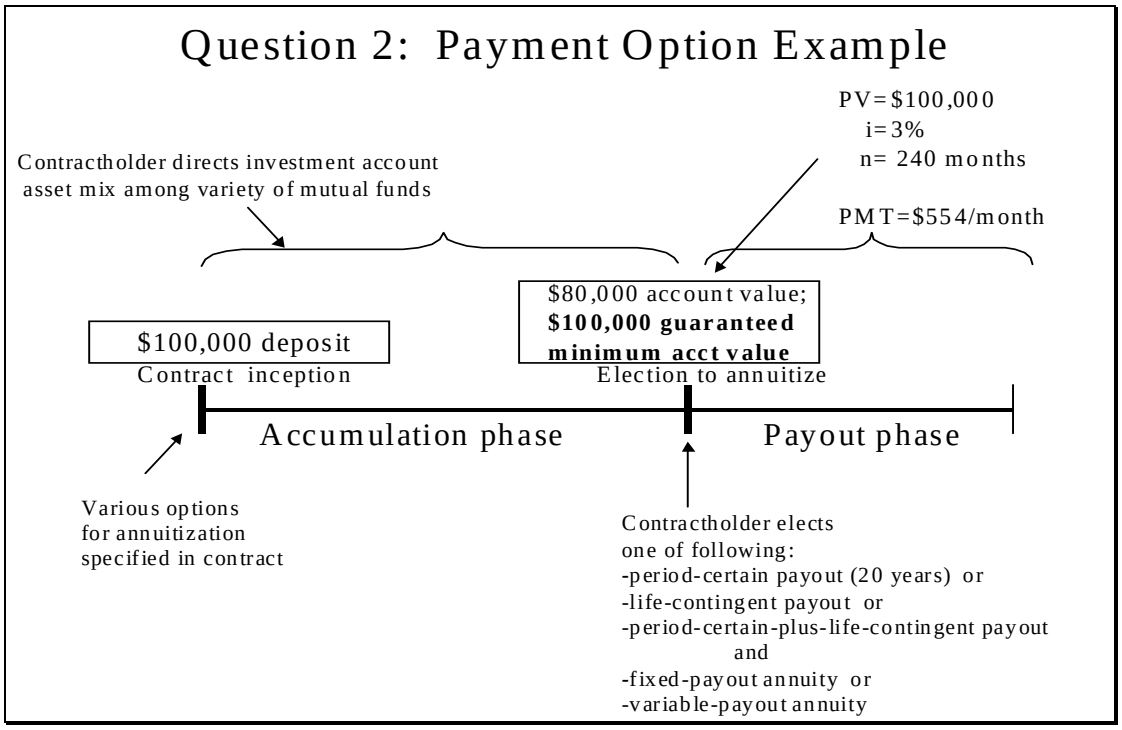
If an additional provision existed whereby the policyholder could withdraw all or a portion of its account balance during the payout phase, an embedded derivative would still not exist because the economic benefit of the guaranteed minimum interest rate would be obtainable only if an entity were to maintain the annuity contract through its specified maturity date.

Background Information Applicable to Question 2

Some deferred variable annuities, in exchange for the issuer's right to charge a fee, may provide a guaranteed minimum amount available to annuitize after a specified period in addition to a guaranteed minimum annuity interest rate (as discussed in Question 1). These benefits are often referred to as guaranteed minimum income benefits, or "GMIBs." These payment alternatives have the effect of modifying the account value at the end of the accumulation period. The following narrative provides an example of this guarantee.

Question 2 Example: The policyholder deposits $100,000 in a deferred variable annuity that provides for a guaranteed minimum interest rate of 3 percent in computing future periodic annuity payments if the policyholder chooses to annuitize at a future date. The policy also specifies that if the policyholder elects to annuitize, the amount available to annuitize will be the higher of the then account value or the sum of deposits made into the deferred annuity. The policyholder directs the $100,000 deposit to equity-based mutual funds within the separate account. At the date that the policyholder chooses to annuitize, the account value has declined to $80,000 due to stock market declines. The policyholder elects a 20-year period-certain fixed payout annuity, payable monthly in arrears. Using the $100,000 guaranteed minimum account value at the date of annuitization and the contractual 3 percent interest rate, the insurance company calculates the policyholder's monthly periodic annuity payments to be $554. Because a fixed-payout annuity is elected, the $554 monthly annuity payment would be fixed throughout the entire payout period.

The following diagram illustrates the payment option discussed in Question 2:



Question 2 (Repeated from Above)

During the accumulation phase of a deferred variable annuity contract, would a provision that guarantees a minimum account value that is available to annuitize if and when a policyholder elects to annuitize require separate accounting as an embedded derivative under paragraph 12 of Statement 133?

RESPONSE TO QUESTION 2

No. The provision that guarantees a minimum account value that is available to annuitize if and when a policyholder elects to annuitize fails to meet the definition of a derivative during the accumulation phase because it cannot be net settled. The benefit of the minimum account value is realized by the policyholder by annuitizing and receiving the economic benefit over the payout term, similar to the above response to Question 1. However, if the policyholder is able to withdraw all or a portion of the guaranteed account balance during the payout (annuitization) period, or the payout (annuitization) period is set to an unrealistically short period such as one year, this is equivalent to net settlement, and the guarantee (or the portion of the guarantee that is withdrawable, if applicable) is an embedded derivative only during the accumulation period.

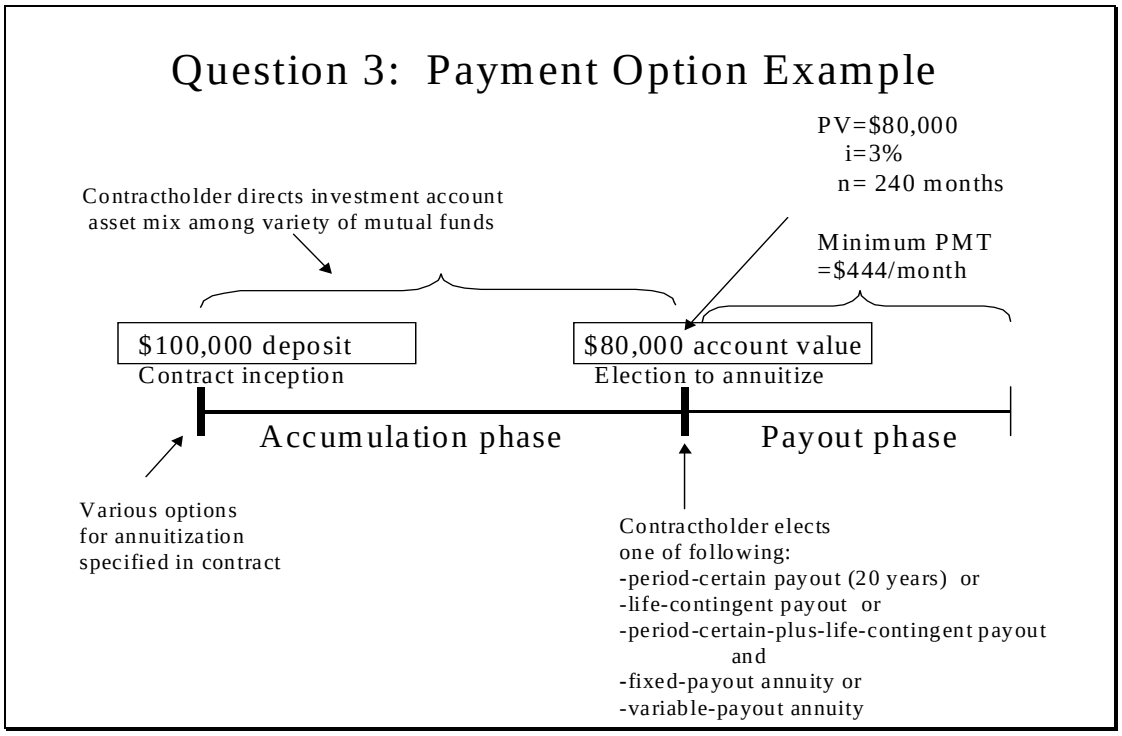
Background Information Applicable to Question 3

Other deferred annuities, instead of providing a guaranteed minimum account value upon annuitization, may instead provide for a variable-payout annuity option with a minimum guarantee on the periodic annuity payments made during the payout phase. That is, once the

payout phase has begun, the periodic annuity payments may be variable (that is, benefits will vary with investment performance of underlying funds, a formula, or an index such as the S&P 500), but with a provision that each periodic payment will be at least equal to a specified minimum amount. The following narrative provides an example of this rate guarantee.

Question 3 Example: The policyholder deposits $100,000 in a deferred variable annuity that provides for a guaranteed minimum interest rate of 3 percent in computing future periodic annuity payments if the policyholder chooses to annuitize at a future date. The policy also specifies that if the policyholder elects a variable-payout annuity option, the insurance company will guarantee a minimum monthly periodic payment during the payout phase that will be calculated using the account value at the annuitization date. The policyholder directs the $100,000 deposit to equity-based mutual funds within the separate account. At the date that the policyholder chooses to annuitize, the account value has declined to $80,000 due to stock market declines. The policyholder elects a 20-year period-certain variable-payout annuity, payable monthly in arrears. The policyholder directs his $80,000 to equity-based mutual funds within the separate account. Using the $80,000 account value at the date of annuitization and the contractual 3 percent interest rate, the insurance company calculates the policyholder's guaranteed minimum monthly periodic annuity payments to be $444. If the mutual funds appreciate such that the variable monthly payment at some future point is recalculated at $500, the policyholder will receive the $500 monthly payment; if the mutual funds decline in value such that the variable monthly payment at some future date before application of the floor guarantee would be $400, the policyholder will receive the agreed-upon floor guarantee amount of a $444 monthly payment.

The following diagram illustrates the payment option discussed in Question 3:



Question 3 (Repeated from Above)

During the accumulation phase of a deferred variable annuity contract, would a provision that guarantees a minimum level of periodic annuity payments during the payout phase if and when a policyholder elects to annuitize into a variable-payout annuity require separate accounting as an embedded derivative under paragraph 12 of Statement 133? This question assumes that the contract is annuitized at its contract value without any floor account value guarantee specified in Question 2.

RESPONSE TO QUESTION 3

No. An embedded derivative does not exist during the accumulation phase of a deferred variable annuity contract because the policyholder cannot net settle the contract. Similar to the Question 1 response, the only way the policyholder can obtain the benefit of the floor payment guarantee is over the life of the variable-payout annuity.

Background Information Applicable to Question 4

Question 3 discussed the accounting *during the accumulation phase* for a *deferred* annuity contract in which the policyholder could choose to annuitize under a variable-payout annuity option and receive a minimum guarantee on the periodic annuity payments to be made during the payout phase. Question 4 addresses the accounting for a variable-payout annuity with a floor payment guarantee *during the payout phase* of the contract. A variable annuity with a minimum guarantee on the periodic annuity payments can also be offered as part of a standalone

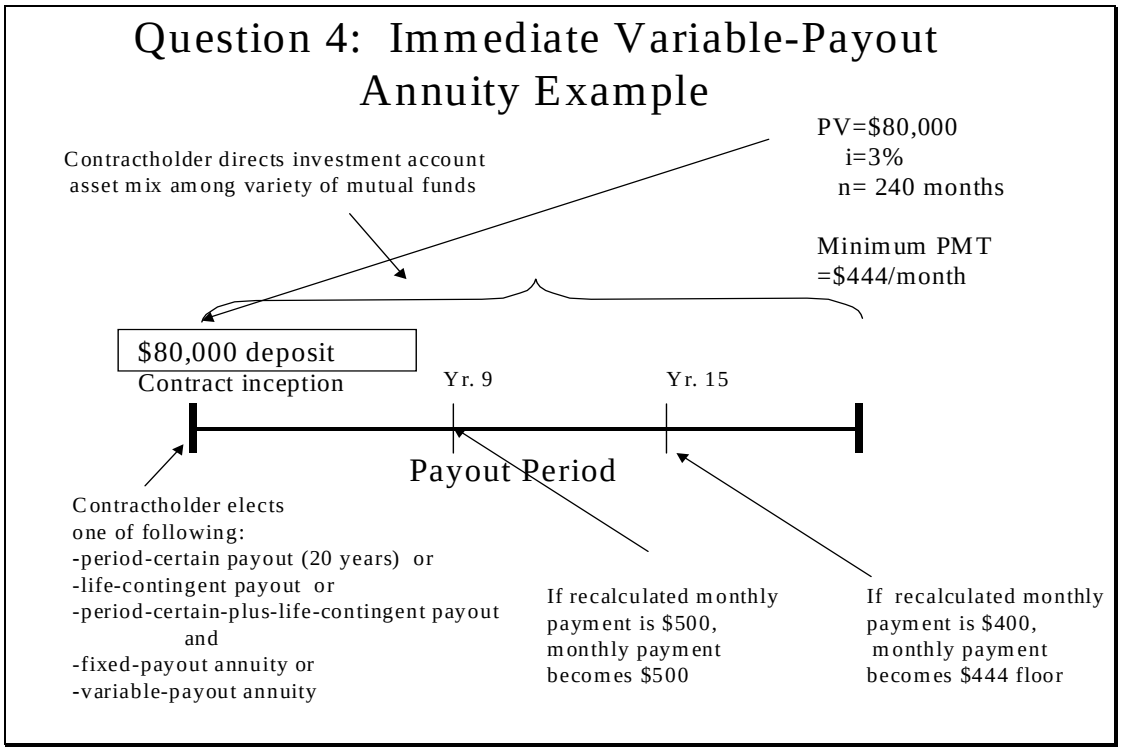
immediate-payout annuity. Like the deferred annuities, the term of the annuity payments may be period-certain, solely life-contingent, or life-contingent-plus-period-certain, and some companies have begun offering annuities with partial withdrawal features during the payout phase. The following narrative provides an example of those payout floor guarantees.

Payout Annuity Example: An existing policyholder with a deferred annuity with an account value of $80,000 elects to annuitize into a variable-payout annuity that provides a minimum guarantee on the periodic annuity payments. Alternatively, a new policyholder with $80,000 to invest may purchase an immediate variable-payout annuity that provides the same minimum guarantee. Both policyholders may elect to incorporate any of the following three payout options in the variable-payout annuity purchased:

- A 20-year period-certain variable-payout annuity, payable monthly in arrears
- A life-contingent variable-payout annuity, payable monthly in arrears
- A 20-year period-certain-plus-life-contingent variable-payout annuity, payable monthly in arrears.

The remaining facts and discussion apply equally to both situations, as they are deemed to be analogous. The policyholder directs the $80,000 to equity-based mutual funds within the separate account. Using the $80,000 deposit at the date of annuitization and the contractual 3 percent interest rate, the insurance company calculates the guaranteed minimum monthly periodic annuity payments to be $444. If the mutual funds appreciate such that the variable monthly payment at some future point is recalculated at $500, the policyholder will receive the $500 monthly payment; if the mutual funds decline in value such that the variable monthly payment at some future date before application of the floor guarantee would be less than $444 (such as $400), the policyholder will receive the agreed-upon floor guarantee amount of a $444 monthly payment.

The following diagram illustrates the payment option discussed in Question 4:



Question 4 (Repeated from Above)

During the payout phase of a variable-payout annuity, would a provision that guarantees a minimum level of periodic payments require separate accounting as an embedded derivative under paragraph 12 of Statement 133? (This type of provision may be found in an immediate-payout annuity contract or in the payout phase of a deferred annuity contract.)

RESPONSE TO QUESTION 4

The accounting treatment for the contractual provision for guaranteed minimum periodic payments is dependent upon the payout option in the variable-payout annuity contract. For the period-certain variable-payout annuity, the guaranteed minimum periodic payments are, during the payout phase, an embedded derivative that is required to be separated under paragraph 12 of Statement 133. This conclusion is based on the assessment that the guaranteed payment floor is not clearly and closely related to the host contract—a traditional variable-payout annuity contract. This is consistent with Statement 133 Implementation Issue No. B8, "Identification of the Host Contract in a Nontraditional Variable Annuity Contract." However, a solely life-contingent variable-payout annuity contract with features described above that meets the definition of an insurance contract under paragraph 8 of Statement 97 would not be subject to the requirements of Statement 133 provided there are no withdrawal features.

For a period-certain-plus-life-contingent variable-payout annuity contract, the embedded derivative related only to the period-certain guaranteed minimum periodic payments would be required to be separated under paragraph 12, whereas the embedded derivative related to the life-contingent guaranteed minimum periodic payments would not be separated under paragraph 12. Separate accounting for the embedded derivative related only to the period-certain guaranteed minimum periodic payments would be required even if the period-certain-plus-life-contingent annuity, in its entirety, meets the definition of an insurance contract under paragraph 8 of Statement 97 and has no withdrawal features.

EFFECTIVE DATE

Implementation guidance on this Issue was originally posted to the website on April 10, 2001. The effective date of the December 19, 2001 revisions to the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after January 9, 2002, the date that the revised Board-cleared guidance was posted on the FASB website. Those revisions related to a period-certain-plus-life-contingent variable-payout annuity contract.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.