TO: Superintendent Joseph Torti III (RI), Chair of the Financial Condition (E) Committee

FROM: Leslie Jones (SC), Chair of the Life Actuarial (A) Task Force

DATE: September 6, 2011

RE: Referral Regarding Separates Account Issues - Request for Clarification and Direction

In response to your referral of March 8, 2011, the Life Actuarial (A) Task Force (LATF) asked the LATF Separate Accounts Subgroup to prepare the following for your consideration.

The referral expressed concern regarding a growing trend by life insurers to include non-unit linked products within the separate accounts. LATF was asked to provide assistance to the Financial Condition (E) Committee, and more specifically the Separate Account Risk Charge (E) Working Group, the Receivership and Insolvency (E) Task Force, the Financial Analysis Handbook (E) Working Group (FAWG), and the Capital Adequacy (E) Task Force, in understanding the features as well as legal and actuarial requirements of these products as they attempt to address the various issues emerging from this trend. The request also made specific note of implications for consumers related to possible avoidance of nonforfeiture requirements.

We plan to prepare our response in four sections.

I. Origin of Separate Accounts

II. Products – Non-Unit Linked

III. Issues

IV. Recommendations

The first three sections are included below. Before LATF proceeds with recommendations we welcome your comments and any additional direction regarding the first three sections. Within this document we have identified several questions to explore and emphasized them in bold font. We would appreciate your comment or reaction to these questions; and welcome your suggestions on additional questions you would advise us to explore in our report.

I. ORIGIN OF SEPARATE ACCOUNTS

Over 50 years ago, the Supreme Court told Variable Annuity Life Insurance Company that federal securities laws required them to set up separate accounts for investment-linked variable annuities. To enable this, the NAIC adopted model laws which were adopted by most of the states. The models were designed to allow the Securities and Exchange Commission (SEC) to regulate variable products (without significant conflict from state insurance regulators) and allow companies to set up separate accounts.

This framework allowed for the potential for greater returns for policyholders, but was accompanied by their assuming the risk of loss of principal. The mechanism to provide those returns incorporated unitized values, where the performance of assets (up or down) was directly passed on to policyholders (i.e., contract values were fully "variable" or "unit-linked"). In exchange for taking on the investment risk, policyholders received insulation of separate account assets supporting reserves (i.e., those assets were "walled-off" from general account creditors).

The most basic application of separate accounts is seen in the pure deferred variable annuity (with none of the optional benefits and guarantees available today). In a simple deferred variable annuity, the customer allocates deposits among the array of investment sub-accounts of the separate account. The underlying assets in these sub-accounts may increase or decrease in value, but through daily "unit-linked" accounting, the investment experience belongs to the customers/annuitants

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in those sub-accounts. In this simple product design, there would be no need to establish general account reserves because the general account has made no guarantees and, therefore, has no liability. All product risks (i.e., the investment risks) are fully borne in the separate account. This is fair to both the general and separate account customers.

Although it took many years, the application of separate accounts has dramatically expanded beyond this simple product design. For example, insurers have been able to create an array of "hybrid" products – products that overlay traditional insurance company guarantees (e.g., mortality, morbidity, etc.) to the separate account investment portfolio. An immediate (payout) variable annuity arguably represents the first such hybrid product. It relies on the separate account framework. And, in the classical immediate variable annuity (i.e., variable payout annuity), the contract holder bears all investment results (through adjustments to all future annuity payments) and the insurer (i.e., general account) bears all mortality risk/rewards. Therefore, the general account stands to lose (or win), based on the actual mortality experience.

Approximately 25 years ago the SEC said it was concerned about credited interest variations forcing investment risk on the consumer (including market value adjustments and indexed products, although there were not many indexed products at the time). Market value adjustments made products violate the nonforfeiture law so the industry (represented by the American Council of Life Insurers—ACLI) desired that these products be placed in separate accounts to avoid the nonforfeiture requirements. In response, the NAIC developed a couple of models – the *Modified Guaranteed Annuity Regulation* (#255) and the *Modified Guaranteed Life Insurance Regulation.* Although few states adopted either, the accounting guidance excerpted from the regulations remains in appendices of the NAIC *Accounting Practices and Procedures Manual (APPM)*. Even though interest rate guarantees are provided, both model regulations provide that separate account assets can be insulated from general account creditors "if and to the extent so provided in the contract." Yet it is not clear regulators and/or industry ever intended to extend insulation to these products.

In the early 1990s many indexed products were developed using separate accounts and were registered with the SEC because the industry assumed the SEC would require it. But most recently the Harkin Amendment in Dodd-Frank said products would not be regulated by the SEC if they comply with the nonforfeiture law. At that point the SEC seemed to lose interest in regulating these products.

In the mid-1990s, to address the growth in the use of separate accounts for guaranteed benefits being funded through group contracts, the NAIC developed the *Separate Accounts Funding Guaranteed Minimum Benefits under Group Contracts Model Regulation* (#200). This provided a regulatory framework for investment return guarantees being provided through such group forms as stable value, participating income annuities, and pension closeouts. Careful attention was given in the development of that model to such matters as insulation of separate account assets supporting contract holder funds versus company funds that might be transferred to the separate account to support the guarantees.

Model laws now exist that permit separate accounts, but no precise definition of the meaning of the term "variable" other than to be a product with "benefits that vary according to the investment experience of a separate account." As a result there seems to be an increase in companies trying to take advantage of the flexibility available through separate account designs. In some cases, these new products may even be simple fixed products, designed to take advantage of the general account reserves required for guarantees in the separate account, but "walling themselves off" via insulation provisions from any problems the general account might have. This may create an unfair discriminatory situation, because if a product is in the separate account the policyholders may perceive that they are getting a "safer" deal than if the product is in the general account. There is no law that allows regulators to constrain a company from putting a product in a separate account.

Indeed, even the design of the immediate (payout) variable annuity raises important issues for consumers, regulators, and insurers. For example, what are the proper reserve levels for the product's mortality guarantees? How does "insulation" work in the event of the insurer's insolvency? And the issues have become more complex considering today's vast array of products and the differences that have been created by variations in state laws/regulations.

II. <u>PRODUCTS – NON UNIT LINKED</u>

The non-unit linked products listed in the FAWG report generally contain modified guaranteed annuities, Bank-Owned Life Insurance (BOLI) and Corporate-Owned Life Insurance (COLI) life insurance products, and products which are often used to fund pension plans including group annuities, guaranteed investment contracts, and funding agreements. There is a smaller number of other products listed in the FAWG report where there is not enough information to determine the type of product it is, whether it is a benefit within a base product and/or whether it is an individual or group product.

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Modified Guaranteed Annuities:

Modified Guaranteed Annuities (MGAs), which are market value adjusted annuities or MVA annuities in the separate account, were created to allow companies to incorporate market value adjustment provisions in deferred annuity contracts that guarantee a current interest rate for a fixed period of years. Market value adjustments are based on interest rate movements post-issue and as such serve as a mechanism for transferring a portion of interest rate risk to the contract holder. Such provisions were believed to contribute to a violation of the annuity nonforfeiture law applicable to fixed individual deferred annuities.

As stated therein, the purpose of the *Modified Guaranteed Annuity Model Regulation* (#255) is “to provide rules for a modified guaranteed annuity, a variable annuity whose assets are placed in a separate account.” Model regulation #255 also states that an MGA “means a deferred annuity contract….the values of which are guaranteed if held for specified periods. The contract contains nonforfeiture values that are based upon a market-value adjustment formula if held for shorter periods.” The nonforfeiture requirements for MGAs differ from those applicable to fixed annuities. Model #255 also provides that separate account assets equal to the reserves and other contract liabilities can be insulated “to the extent set out in the contract.”

Appendix A-255 of the *APPM* (A-255) contains the accounting guidance excerpted from the model regulation and both note that the market value adjustment (MVA) formula “may or may not reflect the value of assets held in the separate account.” A-255 provides that valuation requirements “recognize that assets of the separate account are based on market values, the variable nature of benefits provided, and any mortality guarantees.” Further, A-255 indicates that the separate account liability must at least equal the surrender value based upon the MVA in the contract and “if that liability is greater than the market value of the assets, a transfer of assets will be made into the separate account so that the market value of the assets at least equals that of the liabilities. Any additional reserve that is needed to cover future guaranteed benefits shall be established.”

Group Pension Products:

Group pension products – immediate and deferred payout annuities, Guaranteed Investment Contracts (GICs) and GIC alternatives (e.g., stable value) - are used in defined benefit and defined contribution plans. These products help employers fund pension benefit obligations, provide stable investment options to 401(k) participants, and transfer pension liabilities to an insurance company.

The buyers, plan sponsors, have a fiduciary responsibility to consider the insurer’s credit quality before they make any long term product commitments. While it may be possible to evaluate credit for short periods (say five or ten years), payout annuities involve very long term obligations (e.g., over 50 years). Given the failures of once AAA-rated insurers like Executive Life and Mutual Benefit Life, the separate account’s insulation feature is absolutely vital to the sale of group pension products.

Insulation is arguably the only rational way for insurers to address credit concerns. Without it, sponsors would be forced to turn to other financial institutions for “safer” solutions.

The value of the insulation feature is very much appreciated by federal and state regulators. For example, DOL I.B. 95-1 encourages plan sponsors to consider the structure of the contract (e.g., separate account insulation) when evaluating the “safety” of a group annuity contract. Also, Appendix A-200 of the APPM allows contract holder premiums, contributions and related earnings to be insulated from the creditors of the general account.

Many states, including New Jersey, New York, and Connecticut have fairly clear rules aimed at maintaining the “separateness” of separate account assets. State laws, however, are not always in sync on the issue.

BOLI/COLI:

Bank-Owned Life Insurance (BOLI) and Corporate-Owned Life Insurance (COLI) products are intended to provide a tax-efficient way for banks and corporations to indirectly finance the cost of their non-qualified employee retirement and benefit programs. In both cases, these group life insurance products are a useful and tax-efficient asset/liability management tool. General account and separate account product designs are generally available.

A separate account design offers buyers the opportunity to achieve higher returns than may be possible using conservative general account fixed investments. Separate account designs also provide insurers with flexibility (e.g., investments) to build products that achieve the specific liability objectives defined by the buyers (e.g., banks and corporations).

Life insurance contracts (including BOLI/COLI) offer the potential to accumulate cash value on a tax deferred basis, and pay tax-free insurance proceeds on death of the insured. Since BOLI/COLI purchases are quite large and often involve a long term commitment, insurance company credit risk can be a significant concern. The insulation feature addresses the concern in a straightforward manner.

Under bank accounting rules, life insurance policies funded through the general account place a strain on bank capital. The value of bank-owned life insurance is severely hit (e.g., 50% of cash value, regardless of the insurer's credit rating) if the life insurance policy is funded through the insurer's general account. However, for bank capital requirement purposes, if life insurance policies are funded through a separate account, the accounting rules permit banks to look to the individual assets held in the separate account. This can lead to lower capital requirements for essentially the same product, if the assets in the separate account consist primarily of high quality bonds.

Equity Indexed Annuities not compliant with nonforfeiture requirements

The NAIC model *Standard Nonforfeiture Law for Individual Deferred Annuities* (#805) (SNFLDA) defines the nonforfeiture requirements for deferred annuities. Some recent separate account versions of equity indexed annuities (EIA) are essentially identical to EIAs in the general account except for the significant distinction that the downside protection is less than required by the SNFLDA. A separate account is used because the product does not meet the SNFLDA, and there is a view that a product sold via a separate account means ipso facto it is variable and therefore exempt from the SNFLDA.

Section 2(B) of the model *Variable Annuity Model Regulation* (#250) defines a variable annuity as "a policy or contract that provides for annuity benefits that vary according to the investment experience of a separate account or accounts maintained by the insurer as to the policy or contract, as provided for in Section [insert applicable section] of the laws of this state."

Paragraph 20b of SSAP 50 defines a variable annuity as "an annuity which includes a provision for benefit payments which vary in accordance with the rate of return of the underlying investment portfolio selected by the policyholder. The considerations for a variable annuity are usually invested in a separate account in which the value of the contract share varies according to the performance of the separate account before the commencement of annuity payments as well as after…"

III. ISSUES:

Preferred class of policyholders:

This is the critical issue with respect to any separate account. In a January 1999 article in the *Financial Reporting Section Monograph* Craig Raymond raised this issue noting that:

> The regulatory structure allows a block of policies to be segregated in a SA (separate account) with substantial investment guarantees made to the corresponding policyholders. It also allows the option for the company to insulate these assets from the remaining GA (general account) liabilities while at the same time requiring assets to be maintained in the SA sufficient to fund these liabilities. The result is, in essence, a preferred class of policyholders who have their assets protected from GA liabilities while having first call on GA assets.

A question to explore is whether the current framework inappropriately allows for preferred classes to exist or be created within a separate account to the detriment of the general account.

Insulation:

Related to assessing the potential for a preferred class of policyholders is whether the assets in the separate account are insulated. It is generally assumed that the assets in the separate account backing up the contract are insulated. However, depending on the state this may not be the case.

NAIC Model Variable Contract Law (#260) Section 1D states:

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> If and to the extent so provided under the applicable contracts, that portion of the assets of any such separate account equal to the reserves and other contract liabilities with respect to the account shall not be chargeable with liabilities arising out of any other business the company may conduct.

Another issue relating to the question of insulation pertains to any general account assets that are needed to support the separate account and are transferred into the separate account. Should such general account assets be considered insulated or rather a debt owed back to the general account and treated as other general account assets in a receivership situation?

The subgroup is not aware of or familiar with requirements that may already be in place to answer the question and make clear what is insulated prior to the time of receivership.

If there is uncertainty of what is insulated prior to the time of receivership then another related issue is one of marketing and whether policyholders are led to believe that a non-unit linked product plus any general account assets used to support it are insulated.

Uncertainty of what is insulated prior to receivership may lead to another issue of inconsistency in what is reported for state guaranty fund assessments. To the extent that insulation is unknown for such products then companies have to make assumptions as to what is covered by a guaranty fund in providing information for assessment purposes. There are two supplements currently completed by companies which state guaranty funds use to compute assessments.

The Glossary of SSAP No. 56 defines insulation as:

> The legal protection of separate account assets equal to the reserves and supporting contract liabilities from the general account liabilities of the insurance enterprise ensuring that the separate account contract holder is not subjected to insurer default risk to the extent of their assets held in the separate account.

It is likely that the "person on the street" would expect that his or her policy (contract) is legally protected if marketing information uses the terms "insulated" or "in a separate account." The legal protection would more likely be driven by product approval under a state statute based on either NAIC Model Law #200 or the *Model Variable Contract Law* (#260). One challenge is the reality that not all states have adopted identical versions of the models.

As noted earlier in the Group Pension product discussion, insulation is a critical feature for many plan sponsors because of their fiduciary responsibilities, and especially when it comes to the purchase of the annuities. In New Jersey, New York, and Connecticut, the laws deal with guaranteed separate accounts (vs. the original laws that considered only non-guaranteed, equity-like, accounts). These laws have helped address plan sponsor concerns about whether a guarantee from the general account would invalidate the integrity of the separate account. The laws essentially provide that if the assets in the separate account are insufficient to meet guarantees (e.g., mortality, minimum performance, etc.), then the shortfall is considered a "policy" of the general account. In other words, in the unlikely event of insolvency, the customers of the separate account could end up with more than the market value of the assets in the separate account. NAIC Model Regulation #200 for separate accounts funding guaranteed benefits addresses this general account issue in its provision for non-insulated supplemental accounts.

Because of insulation, separate account customers have a "beneficial interest" in the assets of the account. While the assets are technically held in the insurer's name, the performance of those assets belongs to the customers. This attribute is critical to the sale of BOLI products, as noted in the BOLI/COLI product discussion.

As mentioned above a question to explore is the questionable promotion of insulation in marketing products in a separate account. A more basic insulation question is whether any non-unit-linked product should have had approval of the commissioner to allow it to be in a separate account.

<u>Guarantees</u>:

NAIC Model Law #260 Section 1C states:

> "Except with the approval of the commissioner … reserves for benefits guaranteed … and funds guaranteed … shall not be maintained in a separate account."

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Many of the products identified in the FAWG table include the word “guarantee.” This would suggest that either commissioners have approved such separate accounts or that the approval process is not sufficiently diligent to review filings before they are deemed approved.

A question to explore is whether guarantees have a legitimate place in any separate account, given the preferred class of policyholders and insulation issues discussed earlier. If so, should those guarantees have the benefit of any advantage over general account protections?

Another question to explore is whether contracts sold as variable, but containing guarantees, would be covered by the Guaranty Association. Does the answer depend on the type of guarantee (e.g. the guarantee of a return equal to an index like the Standard and Poor 500, a guaranteed maximum percentage decline in value of an index, or a buffer where the company absorbs the first x% of an index decline and the contract holder is on the risk after that)?

Nonforfeiture requirements:

The nonforfeiture law exempts variable contracts.

A question to explore is whether contracts sold as variable, but containing guarantees, are appropriately exempt from the nonforfeiture law. Does the answer depend on the type of guarantee? Is an updated definition of variable needed?

NEXT STEPS

This is our initial response to your referral. Further exploration of the challenges we see goes beyond actuarial issues. We have tried to present relevant background and a starting point for the next steps with a summary of issues and questions for exploration by actuaries, accountants, liquidators and others. Your reaction will provide valuable direction as we continue this effort.

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