SEPARATE ACCOUNT RISK WORKING GROUP

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**INTRODUCTION**

A separate account is a fund held by a life insurance company that is maintained separately from the insurer’s general assets. Separate accounts were originally established in response to federal securities laws for investment-linked variable annuities. Although it took many years, the application of separate accounts has dramatically expanded beyond this simple product design. Product development has resulted with an array of “hybrid” products—products that overlay traditional insurance company guarantees (e.g., mortality, morbidity, etc.) being allocated to the separate account investment portfolio.

The Separate Account Risk (E) Working Group (SARWG) is currently reviewing the classification of products within separate accounts. The SARWG’s first charge is to study the need to modify existing regulatory guidance related to separate accounts where, in recent years, various products and contract benefits have increased the risk to the general account. At the conclusion of such study, provide a recommendation to the Financial Condition (E) Committee, including a request for model law development/change if the recommendation is for the NAIC to devote its resources to such an effort.

The SARWG’s second charge is to compare the U.S. generally accepted accounting principles (GAAP) definition and requirements for separate accounts to statutory accounting requirements, and use the results of this analysis to help discuss what should be allowed as insulated products. Both charges focus on review and assessment of guidance and products, with direction to provide recommendations to the Financial Condition (E) Committee.

When initially considering these charges in 2012, the SARWG became aware that a revision to the NAIC annual statement blank had been proposed by the Receivership Separate Account (E) Working Group to distinguish insulated and non-insulated products and supporting assets. Pursuant to that proposal, the SARWG noted that addressing its second charge—to discuss which products should (or should not) be allowed insulation—would be beneficial in improving consistency in reporting. Furthermore, determining whether there are products that should not be insulated from general account claims could influence whether a recommendation should be made to devote resources to further modify existing regulatory guidance for separate accounts.

**HISTORY**

The Financial Condition (E) Committee formed the Separate Account Risk (E) Working Group in 2009 at the request of the Statutory Accounting Principles (E) Working Group. The Statutory Accounting Principles (E) Working Group’s recommendation was primarily concerned with the lack of risk charges on individual separate account products in situations when a guarantee is provided by the general account. This concern noted that the lack of a risk charge, or an inadequate risk charge, could create solvency concerns for the general account policyholders. In considering the comments pertaining to risk charges, the SARWG concluded that requiring risk charges, or an actuarial opinion on the adequacy of risk charges may not be the best approach. Rather, the Working Group believed other reporting remedies should be considered to address concerns when guarantees are provided by the general account for separate account products.

During the course of considering its original charge pertaining to risk charges, the SARWG identified several other areas of concern related to separate account products. The SARWG noted a concern that the Variable Contract Model Law (#260), with its provisions regarding guarantees and insulation of separate account assets, could elevate some separate account policyholders unfairly to a position of a preferred class. The concept of a preferred class would include policyholders that hold products with general account guarantees and who could receive preferential treatment of separate account assets during liquidation.

The SARWG also noted a concern about products typically funded through the general account being characterized instead as separate account products and included in the separate account for various reasons. As a result of the discussions, the Working Group agreed that the NAIC should study more closely the financial solvency issues surrounding the separate account in order to recommend whether the NAIC should modify Model #260, as well as other related NAIC model laws and regulations that cover separate accounts.

The second SARWG charge was assigned during the fall of 2011 as a result of the Financial Condition (E) Committee’s identification of non-variable separate account-funded products that could be considered insulated or non-insulated, and the potential legal ramifications that could occur in the event of insolvency.

(Continued on page 15)
**SEPARATE ACCOUNT RISK WORKING GROUP (CONTINUED)**

• **CONSIDERATION OF GAAP**
To first assess separate account product classification, and the insulation of separate account products, the SARWG identified the limitations for separate account reporting under GAAP. In accordance with GAAP requirements, the following four conditions must be met in order for a product to be classified within a separate account:

1. The separate account is recognized legally; that is, the separate account is established, approved and regulated under special rules, such as state insurance laws, federal securities laws or similar foreign laws.

2. The separate account assets supporting the contract liabilities are insulated legally from the general account liabilities of the insurance entity; that is, the contract holder is not subject to insurer default risk to the extent of the assets held in the separate account.

3. The insurer must, as a result of contractual, statutory or regulatory requirements, invest the contract holder’s funds within the separate account as directed by the contract holder in designated investment alternatives or in accordance with specific investment objectives or policies.

4. All investment performance, net of contract fees and assessments, must—as a result of contractual, statutory or regulatory requirements—be passed through to the individual contract holder. Contracts may specify conditions under which there may be a minimum guarantee, but not a ceiling, as a ceiling would prohibit all investment performance from being passed through to the contract holder.

In discussing these elements, it should be specifically noted that separate account allocation for GAAP purposes is mostly a presentation element in the financial statements. These GAAP characteristics intend to identify the products that are owned by an insurer, but for which the contract holder generally has assumed the investment risk. By allocating a product to separate accounts under GAAP, that product is allowed to be reported in the aggregate with all other separate account products.

For GAAP, separate account products are required to be measured and reported at fair value. However, if a product does not meet all four conditions for separate account reporting, other GAAP accounting provisions generally allow continued fair value reporting in the general account. Because all four requirements must be met for separate account reporting under GAAP, it is possible for insulated separate account-funded products to be reported in the GAAP general account. The concept of insulation is a statutory element that provides safeguards for specific products if the company were to enter receivership. Legal insulation safeguards separate account assets as the contract holder is not subject to insurer default risk to the extent of the assets equal to reserves held in the separate account.

• **PROPOSAL TO LIMIT INSULATION BY PRODUCT CHARACTERISTICS**
In accordance with its charges, the SARWG began to analyze the GAAP definition and requirements for separate accounts to statutory accounting requirements, intending to use the results of this analysis to help discuss what should be allowed as insulated products. The SARWG’s initial discussions resulted with a preliminary assessment that insulation limitations, if any, should be based on product characteristics.

In reviewing the GAAP guidance and the concept that insulation may be best attributed to products in which the contract holder bears the investment risk, the SARWG exposed the following characteristics in March 2012, as an initial proposal to determine which products should be eligible for legal insulation:

1. Insurer must, as a result of contractual, statutory or regulatory requirements, invest the contract holder’s funds within the separate account as directed by the contract holder in designated investment alternatives or in accordance with specific investment objectives or policies.

2. All investment performance, net of contract fees and assessments, must—as a result of contractual, statutory or regulatory requirements—be passed through to the individual contract holder. Contracts may specify conditions under which there may be a minimum guarantee, but not a ceiling, as a ceiling would prohibit all investment performance from being passed through to the contract holder.

In proposing these product characteristics, it was clarified that these criteria were not currently being considered to limit separate account classification, but, rather, to determine whether separate account products not meeting these criteria should receive insulation from general account claims. In exposing the identified characteristics for consid-

(Continued on page 16)
eration, the SARWG also noted the following discussion points:

- Only assets purchased with contract holders funds directly attributable to the contract holder (as well as returns on those specific assets that are also completely attributable to a contract holder) should receive legal insulation. Providing legal insulation to assets other that those purchased or attributed directly with contract holder creates a preferential treatment of contract holders.

- Although there is no relinquishment of ownership of assets (assets are owned by the insurer), legal insulation intends to reflect an execution of a contract pursuant to which the insurance enterprise agrees to pass through the separate account investment results to the contract holder (contract holder has assumed the investment risk).

- Separate account products (and related returns) are generally exempt from state investment laws as they are intended to reflect investments directed by a contract holder. By clarifying the products that qualify for legal insulation, it allows for better regulator assessment of the products that should be exempt from state investment laws, and those that should be subject to general account investment limitations.

Comments on the proposed characteristics to limit insulation were received from interested parties. Key aspects of these comments include:

- Interested parties oppose the initial proposed product characteristics as a basis for providing guidance on whether insulation of assets should be allowed under state separate account laws. The proposal that the allowance of insulation be tied to a pass-through of investment results would be a radical change from the current legal and business structure and would be disruptive to the marketplace and to the operations of life insurance companies.

- Insulation is a matter of state law, not accounting, and should be based on solvency, consumer, societal (including non-insurance laws and regulations) and practical considerations. The accounting treatment should follow from legal status under state law.

- While interested parties do not agree with the concept of a “preferred class,” the idea of limiting insulation to assets from funds contributed by the policyholder rather than the company deserves more analysis.

The SARWG discussed these comments via conference call in April 2012. In responding to these comments, it was reiterated that the charge of the SARWG was to discuss what should be allowed as insulated products. It was identified that the action of the SARWG would be to make a recommendation to the Financial Condition (E) Committee regarding its findings. The concept of separate accounts was originally created to handle certain situations (e.g., “pass-through” of investment results), and with separate account product expansion and the evolution of non-variable product features, the SARWG’s intent is to review and recommend on whether there needs to be modifications to existing provisions. It is not intended for the SARWG’s findings and recommendations to be limited to existing state laws.

Additional comments noted that a preliminary review of separate account filings identified potential products that would be outside of the general understanding of an insulated separate account product, such as “fixed products” or “ordinary life insurance.” Although difficult to analyze without knowing product specifics, inquiries were made regarding nonforfeiture requirements, and whether these “fixed” products are subject to the same nonforfeiture requirements as general account products. Discussion occurred on whether classification into a separate account results with a “variable” product distinction, even if the product features are non-variable in nature. This potential “variable” classification and the impact to nonforfeiture requirements were noted as key issues to be deliberated.

Discussion also occurred regarding the concept of a preferred policyholder status, noting that separate account policyholders with non-variable products supported by insulated assets could potentially create a preferred class. The concern is for general account policyholders who might not be aware that the assets of the separate account, which could be guaranteed by the general account, would not be available for general account claims in a company receivership. This concern is particularly true for general account policyholders that have a high-dollar policy outside of what the guaranty fund would cover. It should be noted that the classification of “legal insulation” has not been subject to actual legal interpretation. The issue of insulation benefiting
In addition to the Separate Account Risk (E) Working Group, the Financial Condition (E) Committee has assigned other charges and activities pertaining to separate accounts to other groups. A brief summary and the status of these groups are noted below.

**Financial Analysis (E) Working Group (FAWG)**
FAWG finalized a study in 2011 regarding separate account products. The details of this study are confidential; however, key summary information from their report to the Financial Condition (E) Committee includes:
- 300 products were identified as non-variable, of which 81 were not legally insulated.
- The states appear to have different views on what is defined as legally insulated.
- State insurance department limitations on investments within separate accounts appear to vary widely from state to state.

**Receivership and Insolvency (E) Task Force and Receivership Separate Accounts (E) Working Group**
The Task Force and Working Group were charged with studying receivership issues related to separate accounts and report on possible solutions. The Working Group also was tasked with considering the reporting needs for the current separate accounts mix of products and assets due to consideration with respect to insulated and non-insulated products/assets.
- In 2011, the Blanks (E) Working Group considered a blanks proposal from the Receivership Separate Account (E) Working Group to incorporate separate distinct filings for separate account products that are insulated from the general creditors of the general account and for separate account products that are not insulated. (Under this proposal, an insurance company with both insulated and non-insulated products in the separate account would submit two complete and different filings.) This blanks proposal (2012-25BWG) was adopted by the Blanks (E) Working Group (June 2012) and the Accounting Practices and Procedures (E) Task Force (July 2012).

**Capital Adequacy (E) Task Force**
The Task Force was asked to study the need to modify the risk-based capital formula to capture risks that might not currently be captured.
- This task is anticipated to be originally considered in 2012.

**Financial Analysis Handbook (E) Working Group**
The Working Group was requested to provide enhancements to the Level Two guidance and procedures to the 2010 life/accident & health edition of the Financial Analysis Handbook to cover analysis considerations of the new reporting requirement in the separate account general interrogatories.
- On Oct. 26, 2011, the Working Group adopted additional Level Two guidance and procedures for separate accounts, including expansion of topics such as non-variable products, guarantees, insulated/non-insulated products, etc., that were included in the 2011 life/accident & health edition of the Financial Analysis Handbook.

**Life Actuarial (A) Task Force**
The Task Force was asked to assist the relevant Financial Condition (E) Committee in understanding the features, as well as the legal and actuarial requirements, of separate account products in order to assist the Committee in developing financial regulatory guidance.
- The Task Force provided a response to their research efforts in October 2011.

**Financial Examiners Handbook (E) Technical Group**
The Technical Group was charged with considering the current examination processes and procedures related to separate accounts products/assets to ensure that adequate consideration is given to potential risks arising from these accounts. The Technical Group also was asked to consider the recent changes in the Financial Analysis Handbook and how to leverage the analyst’s work to identify areas for examination activities.
- The Technical Group has discussed this charge and has requested NAIC staff to complete background research and begin drafting proposed guidance, utilizing the guidance completed by analysts in accordance with the Financial Analysis Handbook as a starting point.
preferred policyholders would only be highlighted in an insolvency, so there is little past experience that can be relied upon to determine whether the issue is prevalent.

**Future Discussions**
As a result of the April 2012 conference call, the SARWG has requested time for educational sessions to review details of insulated products, particularly products that do not appear to be “variable” in nature. Public discussions are expected to resume after the SARWG studies specific state provisions and related separate account products.

**Key Article Aspects**
Current SARWG charges are limited to studying, discussing and recommending findings to the Financial Condition (E) Committee. These charges are intended to be addressed without considering existing laws and regulations. Subsequent consideration by the Committee of the SARWG’s recommendations will determine any future direction.

The SARWG has elected to initially focus on the charge to discuss which products should (or should not) be allowed for insulation. It is noted that this distinction would allow for improved consistency in reporting and would influence a recommendation on whether to devote resources to modify existing regulatory guidance.

The concept of separate accounts was originally created to handle “pass-through” situations. Therefore, a review of separate account products and whether they are insulated from the general account is appropriate, given the expansion of products allocated to separate accounts and the evolution of “non-variable” product features.

The SARWG has not yet adopted any recommendations. The SARWG is currently reviewing separate account product specifics via educational sessions. Public conference calls are planned to resume once these educational sessions are concluded.

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**Save the Date**

CIPR Symposium

State of the Life Insurance Industry: Implications of Industry Trends

October 25th and October 26th
Charlotte, North Carolina

Visit the CIPR Events Page for details at:
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