AMERICAN ACADEMY of ACTUARIES

March 25, 2013

Blaine Shepherd
Chair, Separate Account Risk (E) Working Group
National Association of Insurance Commissioners

Dear Blaine:

The Separate Account Products Work Group (SAWG) of the American Academy of Actuaries[1] Life Practice Council appreciates the opportunity to provide comments on the December 20, 2012 document, "Review of Non-Variable, Insulated Products/Product Characteristics with Proposed Recommendations" exposed on January 9 by the Separate Account Risk (E) Working Group (NAIC Working Group).

Context for General and Detailed Comments

The charge of the NAIC Work Group 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." The exposure document reflected this by focusing on only insulated non-unitized[2] separate accounts, but some of the recent discussion seems to touch on the other types of separate accounts. Since we don't think this was the intent of the charge, our comments are limited to issues involving insulation of non-unitized separate accounts and the associated risk to policyholders whose contracts are backed by assets in the general account (hereafter referred to as "general account customers").

The SAWG is aware of two mandated approaches for managing insulated non-unitized separate account assets:

1. One approach involves a requirement to transfer assets from the general account to the insulated separate account to maintain assets at least equal to the required reserves in the separate account. An example of this approach is an insulated separate account established under the Model Modified Guaranteed Annuity (MGA) Regulation

[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

[2] A non-unitized separate account is one in which benefits are declared by the insurer and are not directly related to the assets held in the separate account. This contrasts with a unitized separate account, in which benefits are expressed in units whose value varies directly with the value of the separate account, such as a variable annuity. For the purpose of the NAIC analysis and the SAWG's comments, we are also assuming that unitized separate accounts would include all types of pass-thru separate accounts, including some non-unitized private placement VUL, since the issues being discussed relate to the nature of the product and its risk to the general account, not to how the product allocates separate account assets among policy or contractholders.

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(NAIC Model 255), where the company elects to insulate the separate account assets.[3] Since NAIC Model 255 requires companies to hold assets at least equal to reserves in the separate account, this requires the company to transfer assets from the general account to address any shortfalls.

2. Under the second approach there is a prohibition of transfer of assets from the general account to an insulated separate account, even when reserves are in excess of assets. An example of this approach is an insulated separate account established under the Separate Accounts Funding Guaranteed Minimum Benefits Under Group Contracts Model Regulation (NAIC Model 200), which prohibits the transfer of assets from the general account into such insulated separate accounts. Separate accounts established for group annuities under NAIC Model 200 limit the assets that can be insulated to (i) amounts contributed (net of withdrawals) by the contractholder, and (ii) the earnings attributable to the amounts contributed (net of withdrawals[4]) by the contractholder. Thus, the insulated separate account is essentially self-funded. To the extent that reserves exceed the assets in these separate accounts, assets are required to be held either in the general account or in a non-insulated separate account (referred to as a "supplemental account").[5] Therefore, assets held in insulated separate accounts following this approach (i.e., those subject to NAIC Model 200 as well as other separate accounts that use a similar approach) are not necessarily sufficient to support guaranteed customer benefits. As a result, in the event of an insolvency, contractholders supported by these separate accounts would have to "stand in line" with other contractholders in order to receive benefits funded by assets that are not held and insulated in the separate account (i.e., any guaranteed customer benefits in excess of the assets in the separate account).[6]

One of the two approaches outlined above (or something in between) may also be utilized with insulated separate accounts where asset transfers from the general account are neither required nor prohibited by regulation. We believe BOLI VUL and UL products fit in this category, and that the amount of assets (or assets relative to full reserves) the insurer chooses to place in the insulated separate account may vary by company and/or product (e.g., separate account assets may be guaranteed to be at least equal to 95% of reserves). The exact approach would be dictated by company practice and the terms of the agreement(s) among the company, the bank and/or the policyholders.

Our comments below reflect these two approaches for insulating non-unitized separate account assets.

General Comments

[3] NAIC Model 255 neither requires nor prohibits insulating separate accounts that support modified guaranteed annuities. SAWG is aware that both insulated and non-insulated separate accounts supporting these products exist, and the NAIC Working Group's Product Review confirms this. Our comments here focus solely on the separate accounts that are insulated.

[4] We believe the term "withdrawals" is meant to be very broad and intended to cover any reduction to the account value, including charges, fees, expenses, profit margins, etc.

[5] Per section 7.E., 8.C., 9.B. and 4.Y. of NAIC Model Regulation 200.

[6] Insulated separate accounts using this approach, including those that are established under NAIC Model 200, may also support contracts that deduct risk charges from the separate account and pays them to the general account.

- The caption of the document refers to “Non-Variable, Insulated Products.” We suggest that it be changed to “Non-Unitized, Insulated Products” because we believe it better fits the issues that the NAIC Working Group is studying. For example, NAIC Model 255 defines modified guaranteed annuities (MGAs) (more generally known as market value adjusted annuities (MVAs)) as “a type of variable annuity,” but these are properly included in your chart. We suggest that the term “non-variable” be replace with “non-unitized” where it appears throughout the document.
- We suggest that the analysis of each grouping include a section called “Impact of Insulation.” This will aid in identifying the impact of insulation upon general account customers, insurers, and guaranty funds, which varies among the various groupings. Our comments below include our analysis of those impacts.

<u>Detailed Comments</u>

- **Grouping A** (MVA/MGAs)
  a. It should be noted that there are two types of market valued adjusted annuity (MVAs) products that are written in insulated[7] separate accounts:
     1) Products that are registered as securities because they do not meet the safe harbor requirements of SEC Rule 151, which is why they are securities. Registered products have a flexible nonforfeiture floor that is defined in NAIC Model 255 (unfloored MVAs).
     2) Products that are not registered as securities because they meet the safe harbor requirements of SEC Rule 151. The non-registered products have a fixed nonforfeiture floor according to the Standard Nonforfeiture Law for Individual Deferred Annuities (floored MVAs). These products are not written under NAIC Model 255, but some aspects of Model 255 are drawn upon.

     Although NAIC Model 255 was designed for unfloored MVAs and was adopted in only a minority of the states, it is our understanding that most states use the NAIC Model 255 as the basis for approving MVAs in separate accounts, whether they are floored or not. As a result, we believe the impact of insulation would be the same on both types of products.
  b. We suggest this grouping also include indexed annuities containing market value adjustments, and fixed or indexed annuity “buckets” with a market value adjustment that are written with variable annuities, where the assets are held in an insulated separate account.
  c. **Impact of Insulation –** For MGA annuities written under NAIC Model 255, where the insurer opts to insulate the separate account, assets are required to be at least as great as the reserves; consequently, it may be necessary to transfer assets from the general account to the separate account. The reserves should generally make it possible to pay full benefits in the event of insolvency. This could reduce the funds available to general account customers, although transfers could be compensated for by subsequent reserve releases (i.e., “preferred status” could be a transitory phenomenon). A “preferred status” of the products, when written in an

[7] This discussion is limited to insulated separate accounts, and does not address any issues associated with non-insulated separate accounts, whether or not they were written under NAIC Model 255.

insulated separate account, can happen in several ways: (1) The separate account assets can "self-fund" all of its reserves, while general account assets becomes inadequate on their own, or (2) general account assets can subsidize the insulated separate account for inadequate asset build up. There is a risk that guaranty fund liabilities could be increased if the insulated separate account obligations exceed any guaranty fund ceiling that would otherwise apply if it had been a non-insulated general account obligation.

- **Grouping B** (Fixed Annuities)
    a. The number of contracts (69) in this category seems surprisingly high; consequently, it may be helpful to take a closer look at the source material to determine whether any of these belong in Grouping A (e.g., a fixed annuity with a market value adjustment that was categorized as only a fixed annuity). It also would be helpful to know why these products are written in a separate account and why the separate account assets are insulated.
    b. **Impact of Insulation –** This is unclear without understanding whether these products belong in Grouping A or why these products were written in a separate account. As we said on page 2 of the "Context…" section of this letter, the impact may depend upon the amount of assets (relative to full reserves) the insurer chose to place in the insulated separate account.

- **Grouping C** (BOLI/COLI)
    a. On the Stable Value Protection (SVP) issue, we believe it would be helpful to provide you with some background/context for the use of SVPs. This background is based on the SAWG's observations of the history of this product and the marketplace today, and not a detailed study. The OCC 2004-56 Guidance was promulgated at a time when BOLI products were commonly VUL policies (invested primarily in bond funds) backed by a unitized separate account that supports a stable value account. The SVP was introduced to reduce volatility on the bank purchaser's balance sheet due to declines in market value attributable to changes in interest rates, since this is an investment viewed in the long term. SVPs were generally provided by 3rd parties (usually banks) and would be a contract between the bank purchaser and the 3rd party bank. These contracts were totally separate from the insurance company contracts, with no liability expected on the part of the insurance company if the 3rd party SVP provider fails to make a payment. Consequently, from our observations of the marketplace, these contracts are not relevant to the current discussion of separate account insulation.

       When the financial crisis hit in 2008, the banks effectively withdrew from the SVP business by pricing themselves out of the market. To be able to continue to compete in the marketplace, insurers began offering SVP coverage themselves, either through the general account or through a non-life company within their holding company group. To limit their risk exposure, insurers began incorporating new design elements into their products and reduced SVP guarantees. In situations where the guarantee was provided by the general account, the amount of the guarantee or some percentage of it (as provided in the contract) would be transferred from the general account to the insulated separate account (and held separately from the VUL policy funds) to ensure that the entire surrender value (or a significant percentage) was insulated.

Because at this point the insurer was providing the entire BOLI coverage, insurers decided they could reduce the complexity of the arrangement by providing the coverage through a UL policy in an insulated separate account, and transferring funds from the general account to the separate account as needed to provide the guarantee. Charges for such a guarantee then became implicit rather than explicit. Some companies offer a BOLI product that is a UL policy with reserves in an insulated separate account and where assets supporting any guarantees beyond what is in the separate account are held in the general account or a non-insulated separate account. Some companies transfer periodically any excess in the separate account over the guarantee to the general account.

In summary, the BOLI products that are ***inforce*** today and which we have observed are generally as follows:

- VUL policies with a 3rd party SVP (rarely sold today, but there are inforce blocks outstanding)
- VUL policies with an SVP provided by a non-life company within the VUL insurer's holding company group (sales have become less common, but there are inforce blocks outstanding)
- VUL policies with a guarantee provided through the general account with periodic sweeps of the amount of the guarantee into a separate section of the insulated separate account (sales have become less common, but there are inforce blocks outstanding)
- UL policies in an insulated separate account (a common product being sold in the marketplace today) where any of the following practices may be in place:
    - Funds are transferred from the general account to the separate account as needed to match the liabilities of the UL policy
    - Supplemental assets beyond those in the separate account are held in the general account or a non-insulated separate account
    - Funds in the separate account in excess of the UL guarantee may be periodically transferred to the general account.

b. From what we have observed, BOLI (bank) and COLI (non-bank) purchasers have different objectives, which would suggest that they be put into two separate product groupings.

    - Non-banks are looking for tax-effective insurance policies to fund their benefit programs, which are long term and appear to most often result in purchasing policies backed by equity-funded separate accounts. Banks are likewise looking for tax-effective insurance policies to fund their benefit programs, but they also have broader objectives that are served well by purchase of insurance policies backed by bond-funded separate accounts.

- The product the bank buys will need to allow an RBC look through that reduces the bank's RBC requirements. This is a non-issue for non-banks.
- Banks are not willing to live with volatility on their balance sheet, due to detailed and frequent financial reporting requirements. Non-banks are not subject to such requirements, so they are willing to live with the volatility in their financial statements. The result is that COLI is usually funded by VUL policies without any type of SVP protection.

Based on the above, we suggest that COLI products backed by a non-unitized separate account be in a separate category from BOLI, or that it be noted that separate account insulation issues that are being addressed in the product chart would not necessarily apply to COLI.

c. **Impact of Insulation –** For BOLI products, asset transfers from the general account are neither required nor prohibited by regulation. Therefore, as we said on page 2 of the "Context…" section of this letter, the impact may depend upon the amount of assets (relative to full reserves) that is contractually guaranteed or that the insurer chose to place in the insulated separate account. If the guarantee is provided through a formal third party provided SVP contract there would be no impact on insulation.

- **Grouping D** (Generally appears to be Group Annuity Coverages – Accumulation Phase)
  a. **Impact of Insulation –** As noted above, NAIC Model 200 limits the assets that can be insulated to (i) amounts contributed (net of withdrawals) by the contractholder, and (ii) the earnings attributable to the amounts contributed (net of withdrawals) by the contractholder.[8] Although contract liabilities may be in excess of the assets in the insulated separate account, the insulated assets are essentially self-funded and there is no risk to the general account. Also, it is not required that the assets in the separate account equal this limit. If the insulated contract obligations in the separate account are more fully funded than those in the general account at the time of an insolvency, there could be additional guaranty fund exposure (as discussed in item c under Grouping A) .

- **Grouping E** (Generally appears to be Group Annuity Coverages – Payout Phase)
  a. This grouping needs a clearer characterization. If the single premium annuities are individual products, they could probably be addressed in Groupings A or B. (Some income annuities do include a market value adjustment in commutation calculations.) If they are pension buy-outs or buy-ins, they reflect the same objectives (e.g., protection of plan assets and/or participant benefits) as the products in Grouping D; consequently, they may belong in Grouping D. While the products in Grouping D may have cashout values, the products in Grouping E contain income payout obligations; consequently, they face the same risks in the event of an insurer insolvency and could be viewed together. Both "experienced-rated" and "non-experience-rated" appear to be characteristics of group annuities,

[8] NAIC Model Regulation 200, Section 4, Y and Section 9, B.

which suggest they could be included in Grouping D. If these products represent the payout phase of a product in Grouping D they likely belong in Grouping D.
   b. **Impact of Insulation –** If any products remain in this group, the impact probably would be identical to that in Grouping D.

- **Grouping F** (Indexed Annuities)
   a. Just as with products in Grouping A, these products need to be differentiated between non-registered (which may be the vast majority) and the registered (which may be very few). Indexed annuities that are in a separate account and insulated should be included in Grouping A if they have a market value adjustment and included in Grouping B if they do not. As a result, there is no need for this Grouping.

- **Other Products**
   a. The term "Investment Annuity" historically referred to a type of variable annuity. Its use here should be clarified and the product should be placed in one of the existing groupings.

- **Other Issues**
   a. Since Rule 151A does not exist, it is best to exclude commentary on it.

We will continue to follow this issue and offer additional comments as appropriate. In the meantime, if you have any questions, please contact John Meetz, the Academy's life policy analysis, at 202-223-8196 or meetz@actuary.org.

Sincerely,

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Chairperson
Separate Account Products Work Group
American Academy of Actuaries

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