Separate Account Risk (E) Working Group
Exposure Document

Document: Non-Variable, Insulated Products / Product Characteristics with Proposed Recommendations – Draft Date: Dec. 20, 2012

Exposure Date: January 9, 2013

Deadline for Receipt of Written Comments: **Monday, February 25, 2013**

Comment Request:

Comments should not simply register agreement or disagreement without a detailed explanation, a description of the impact of the proposed guidance, or possible alternative recommendations. Responses would be most beneficial if they provide specific comments, including discussion of:

- Information / impact of proposals on fiduciary responsibilities
- Differences between general account / separate account policyholders, advantages to separate account policyholders, and the reasons for these differences and advantages.

All components of the exposure document are open for comment, but the following are key areas in which comments are specifically requested:

- Product Groupings and Attributes – Are the groupings appropriate for like products? Do any of these products have additional attributes that should be specifically identified?
- Assessments – Are the assessments accurate based on the attributes of the products?
- Proposed Recommendations – Based on the attributes, do you agree/disagree with the proposed recommendation? Are there factors not reflected that would influence the proposed recommendation? Should application of the recommendation be applied on a prospective or retrospective basis?
- Specific Questions – The document includes a few noted issues for which additional information is requested. Comments are requested on these items, which include:
    - Grouping C – Relevance/frequency of SVP contracts
    - Grouping C & D – Market impact of insulation and additional attributes of these products that may influence the proposed recommendation.

Any individual or organization may send written comments addressed to Blaine Shepherd, Chair of the Separate Account Risk (E) Working Group, to the attention of Julie Gann at jgann@naic.org, no later than **February 25, 2013**. Electronic submission is preferred.

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Separate Account Risk (E) Working Group

Non-Variable, Insulated Products / Product Characteristics with Proposed Recommendations

This document focuses on non-variable, insulated products identified in the Feb. 9, 2011, Financial Analysis (E) Working Group (FAWG) memo to the Financial Condition (E) Committee. Products identified as not legally insulated through that survey are not detailed in this document as the current focus of the Separate Account Risk (E) Working Group is to provide a recommendation regarding what should be allowed as insulated products. The purpose of this document is to review non-variable, insulated products and identify whether such products have characteristics that support insulation from general account claims, and, if so, identify those characteristics.

The FAWG Feb. 9, 2011, memorandum is the result of a FAWG survey to the states. As it is based on survey responses, the information reported may not be all-inclusive of the types of non-variable, insulated products and/or the number of products.

Grouping A	Attributes
Market Value Adjusted Annuity Modified Guaranteed Annuity	• Non-variable – Provides fixed (guaranteed) interest rates for specified periods. • Market – Fluctuations impact surrender value (if holder surrenders the contract) or subsequent interest rate guaranteed periods. • Investments – Contract holder does not elect specific investments. • Performance – Payments to contract holder do not reflect actual investment proceeds (net of fees), but may reflect market value adjustment on surrender. • SEC Rules – Product would generally meet the "safe harbor" requirements under Rule 151 and is considered an insurance contract as 1) the insurer assumes the investment risk under the contract and 2) the contract is not marketed primarily as an investment[1].
Guaranty Fund Review	These products should <u>not</u> generally be deducted from the premium assessment base. The deduction from the assessment base does not depend on separate account or insulation status, but rather whether the product provides a guarantee. As these products provide a guarantee, they should be captured within the assessment base, and be within the scope of the guaranty fund - not considering other restrictions (e.g., size) - in the event of an insolvency.
Assessment	Underlying product is a fixed product providing guaranteed interest rate returns similar to general account products subject to non-forfeiture requirements.
Proposed Recommendation	**These products are similar to general account products. Furthermore, these products have characteristics that meet the safe harbor requirements of SEC Rule 151. It is recommended that these products (and products with different names, but similar characteristics) be identified to the Financial Condition (E) Committee as products that <u>should not be</u> insulated from general account claims:** **Impact per the Feb. 9, 2011 FAWG Memo: (102 in separate accounts, 49 insulated)** • **Market Value Adjusted Annuities – 67 in separate accounts, <u>19 insulated</u> and 48 were not legally insulated.** • **Modified Guaranty Annuities – 35 in separate accounts, <u>30 insulated</u> and 5 not legally insulated.**

[1] The determination of whether a security meets the "safe harbor" requirements under Rule 151 is the underlying threshold for this assessment. The registration of products that meet the safe harbor requirements does not impact the actual variable / non-variable characteristics of a product. Such registered products are still not recommended to be suitable for insulation as the product still has the following characteristics: 1) the insurer assumes the investment risk under the contract and 2) the contract is not marketed primarily as an investment.

<table>
<tr><th>Grouping B</th><th>Attributes</th></tr>
<tr><td></td><td></td></tr>
<tr><td>Flexible Premium Deferred Annuity
Deferred Annuity
Fixed Annuity
Fixed Income
Fixed Credited Interest Rate</td><td>• Non-variable – Provides fixed (guaranteed) interest rates which may be periodically reset to reflect changes in the market environment.
• Market – Can impact fixed interest rates in renewal periods and, accordingly, contract value if annuitized and/or paid to beneficiaries.
• Investments – Contract holder does not generally elect specific investments, but may be permitted to select options depending on the product structure.
• Performance – Payments to holder do not reflect actual investment proceeds.
• SEC Rules – Product would generally meet the “safe harbor” requirements under Rule 151 and is considered an insurance contract as 1) the insurer assumes the investment risk under the contract and 2) the contract is not marketed primarily as an investment.</td></tr>
<tr><td>Guaranty Fund Review</td><td>These products should <u>not</u> generally be deducted from the premium assessment base. The deduction from the assessment base does not depend on separate account or insulation status, but rather whether the product provides a guarantee. As these products provide a guarantee, they should be captured within the assessment base, and be within the scope of the guaranty fund - not considering other restrictions (e.g., size) - in the event of an insolvency.</td></tr>
<tr><td>Assessment</td><td>Underlying product is a fixed product providing a guaranteed interest rate, subject to reset, for set periods. Product is similar to general account products that would be subject to non-forfeiture requirements.</td></tr>
<tr><td>Proposed Recommendation</td><td>These products are similar to general account products. Furthermore, these products have characteristics that meet the safe harbor requirements of SEC Rule 151. It is recommended that these products (and products with different names, but similar characteristics) be identified to the Financial Condition (E) Committee as products that <u>should not be</u> insulated from general account claims:

Impact per the Feb. 9, 2011 FAWG Memo: (69 in separate accounts, 53 insulated)

• Flexible Premium Deferred Annuities – 40 in separate accounts, <u>38 insulated</u> and 2 were not legally insulated.

• Deferred Annuities – 12 in separate accounts, <u>9 insulated</u> and 3 were not legally insulated.

• Fixed Annuities - 12 in separate accounts, <u>5 insulated</u> and 7 were not legally insulated.

• Fixed Income - 3 in separate accounts, <u>1 insulated</u> and 2 were not legally insulated.

• Fixed Credited Interest Rate - 2 in separate accounts, <u>0 insulated</u> and 2 were not legally insulated.</td></tr>
</table>

Grouping C	Attributes
BOLI COLI	• Non-variable – Generally provides term life / whole life / universal life insurance on employees. • Market – Product is not generally at risk by market or other financial fluctuations. Fluctuations may impact subsequent interest rate guarantees. • Investments – Contract holder does not elect specific investments. • Performance – Payments to holder do not reflect actual investment proceeds. • Bank Capital – Banks receive reduced capital charges if BOLI investments are held in an insulated separate account. • SEC Rules – Product would generally meet the "safe harbor" requirements under Rule 151 and is considered an insurance contract as 1) the insurer assumes the investment risk under the contract and 2) the contract is not marketed primarily as an investment.
Guaranty Fund Review	These products should <u>not</u> generally be deducted from the premium assessment base. The deduction from the assessment base does not depend on separate account or insulation status, but rather whether the product provides a guarantee. As these products provide a guarantee, they should be captured within the assessment base, and be within the scope of the guaranty fund - not considering other restrictions (e.g., size) - in the event of an insolvency. For BOLI/COLI products, size limits ($5 million per contract) are factors for these products. In such instances, the premium received for the portion of the product in excess of the guaranty fund size limitations would be deducted from the assessment base.
Assessment	Underlying product is a fixed product providing a guaranteed interest rate for set periods. Product is similar to general account products that would be subject to non-forfeiture requirements. Key difference between this product and general account products is the bank desire to receive a reduced capital charge if the product is considered insulated from general account claims. *In OCC2004-56, there is reference that the insurer may have an SVP contract from the insurance carrier or by a third party to protect the policyholder from declines in the fair value of separate account assets. Per the document, under most arrangements, the insurance carrier is not responsible for making a payment under the SVP contract if a third-party protection provider fails to make payments to it. Stable Value Providers may provide products that, depending on the "institutional separate account's" (providing insulation from credit risk and other plan cash flows) cash flow and performance of assets, pay either a fixed rate or credit a periodic return.* *It is still uncertain to what extent insurers have purchased this coverage for separate accounts.* ***(The Working Group is looking for additional information regarding these arrangements, prevalence, etc.)***
Proposed Recommendation	**These products – as they provide standard life insurance – do not have any contract elements that would warrant inclusion in an insulated separate account. Products with these (or similar) characteristics that meet the safe harbor requirements of SEC Rule 151 generally should not be insulated from general account claims.** ***However, the insulation classification for BOLI products may be a factor for the product market. Although the attributes for this product are similar to general account products, it was identified that eliminating insulation classification would be a change for the banks, and if this change occurs, the banks may look to other products / providers. The Working Group is aware that much of this business is insulated and prohibiting insulation could be disruptive to the market. <u>Further discussion on this grouping is needed, along with input from industry and consumer reps.</u>*** **Impact per the Feb. 9, 2011 FAWG Memo: (40 in separate accounts, 39 insulated)** • **BOLI/COLI – 40 in separate accounts, <u>39 insulated</u> and 1 not legally insulated.**

Grouping D	**Attributes**
Guaranteed Investment Contract Guaranteed Interest Funding Agreement Group Annuity Group Annuity Contract Guaranteed Group Annuity (Pooled / Non-Pooled) Group Annuity-Funding Agreement	• Non-variable – Offers a fixed interest rate that may be reset based on separate account investment performance before contract maturity. • Market – Product may or may not be at risk by market or other financial fluctuations, depending on interest rate reset provisions. • Investments – Contract holder does not elect specific investments. • Performance – Payments to holder do not reflect actual investment proceeds. • SEC Rules – Product would generally meet the "safe harbor" requirements under Rule 151 and is considered an insurance contract as 1) the insurer assumes the investment risk under the contract and 2) the contract is not marketed primarily as an investment.
Guaranty Fund Review	These products should <u>not</u> generally be deducted from the premium assessment base. The deduction from the assessment base does not depend on separate account or insulation status, but rather whether the product provides a guarantee. As these products provide a guarantee, they should be captured within the assessment base, and be within the scope of the guaranty fund - not considering other restrictions (e.g., size) - in the event of an insolvency.
Assessment	Underlying product is a fixed product providing a guaranteed interest rate for set periods. Interest rate may have incidental floor guarantee and be reset based on separate account investment performance. Product is similar to general account products that provide similar guarantees.
Proposed Recommendation	**These products are similar to general account products. Furthermore, these products have characteristics that meet the safe harbor requirements of SEC Rule 151. It is recommended that these products (and products with different names, but similar characteristics) be identified to the Financial Condition (E) Committee as products that <u>should not be</u> insulated from general account claims:** ***The insulation classification for Grouping D products may be a factor for the product market. Although the attributes for this product group are similar to those for general account products, it was identified that eliminating insulation classification would be a significant change for the large stable value marketplace. The Working Group is aware that much of this business is insulated and prohibiting insulation could be disruptive to the market. <u>Further discussion on this grouping is needed, along with input from industry and consumer reps.</u>*** **Impact per the Feb. 9, 2011 FAWG Memo: (57 in separate accounts, 55 insulated)** • **Guaranteed Investment Contracts – 3 in separate accounts, <u>3 insulated</u> and 0 were not legally insulated.** • **Guaranteed Interest – 1 in separate accounts, <u>1 insulated</u> and 0 were not legally insulated.** • **Funding Agreements - 10 in separate accounts, <u>9 insulated</u> and 1 were not legally insulated.** • **Group Annuity - 16 in separate accounts, <u>15 insulated</u> and 1 were not legally insulated.** • **Group Annuity Contracts - 14 in separate accounts, <u>14 insulated</u> and 0 were not legally insulated.**

<table>
<tr><th>Grouping E</th><th>Attributes</th></tr>
<tr><td></td><td></td></tr>
<tr><td>Single Premium Annuity
Experience Rated Contracts
Non-Experience Rated Contracts</td><td>• Non-variable – Offers fixed payment schedule to individual payees after purchase of annuity.
• Market – Product is not at risk by market or other financial fluctuations.
• Investments – Contract holder does not elect specific investments.
• Performance – Payments to holder do not reflect actual investment proceeds.
• SEC Rules – Product would generally meet the “safe harbor” requirements under Rule 151 and is considered an insurance contract as 1) the insurer assumes the investment risk under the contract and 2) the contract is not marketed primarily as an investment.</td></tr>
<tr><td>Guaranty Fund Review</td><td>These products should <u>not</u> generally be deducted from the premium assessment base. The deduction from the assessment base does not depend on separate account or insulation status, but rather whether the product provides a guarantee. As these products provide a guarantee, they should be captured within the assessment base, and be within the scope of the guaranty fund - not considering other restrictions (e.g., size) - in the event of an insolvency.</td></tr>
<tr><td>Assessment</td><td>Underlying product is a fixed product providing annuity payments (that may be immediate or deferred) to individual payees. Product is similar to general account products that provide similar guarantees.</td></tr>
<tr><td>Proposed Recommendation</td><td>These products are similar to general account products. Furthermore, these products have characteristics that meet the safe harbor requirements of SEC Rule 151. It is recommended that these products (and products with different names, but similar characteristics) be identified to the Financial Condition (E) Committee as products that <u>should not be</u> insulated from general account claims:

Impact per the Feb. 9, 2011 FAWG Memo: (11 in separate accounts, 10 insulated)

• Single Premium Annuity – 6 in separate accounts, <u>5 insulated</u> and 1 were not legally insulated.

• Experience Rated Contracts – 4 in separate accounts, <u>4 insulated</u> and 0 were not legally insulated.

• Non-Experience Rated Contracts - 1 in separate accounts, <u>1 insulated</u> and 0 were not legally insulated.</td></tr>
</table>

Grouping F	Attributes
Fixed Index Deferred Annuities Equity Index Annuities	• Non-variable – Primary product attribute is an interest rate based on index returns, where a minimum guaranteed interest rate may also apply. • Investments – Contract holder does not elect specific investments. • Performance – Payments to holder do not reflect actual investment proceeds. • SEC Rules – Although the SEC Rule 151A was listed as "final" and effective January 12, 2011, it has been identified that the US Court of Appeals for the District of Columbia vacated SEC Rule 151A. Furthermore, the Financial Services Reform conference bill was passed by the US Senate, resulting with the SEC Rule 151A being defeated by Federal Law. **As a result, fixed index annuities with minimum guaranteed interest rates will not be subject to SEC registration.**
Guaranty Fund Review	These products should not generally be deducted from the premium assessment base. The deduction from the assessment base does not depend on separate account or insulation status, but rather whether the product provides a guarantee. As these products provide a guarantee, they should be captured within the assessment base, and be within the scope of the guaranty fund - not considering other restrictions (e.g., size) - in the event of an insolvency.
Assessment	Underlying product is a fixed product that may provide a guaranteed interest rate and/or an interest rate based on one or more indices, for set periods. If a minimum guaranteed interest rate applies, product is similar to general account products that provide similar guarantees and are subject to non-forfeiture requirements. *If a minimum guaranteed interest rate does not apply, and index returns can be negative, SEC registration and non-forfeiture issues arise.*
Proposed Recommendation	**If a minimum guaranteed interest rate applies, these products are similar to general account products. Furthermore, these products then have characteristics that meet the safe harbor requirements of SEC Rule 151. As such, it is recommended that these products (and products with different names, but similar characteristics) be identified to the Financial Condition (E) Committee as products that should not be insulated from general account claims:** **Impact per the Feb. 9, 2011 FAWG Memo: (15 in separate accounts, 12 insulated)** • **Fixed Index Annuity – 3 in separate accounts, 3 insulated and 0 were not legally insulated.** • **Equity Index Annuities –2 in separate accounts, 2 insulated and 0 were not legally insulated.**

The following products also have been identified with instances of insulation classification in separate accounts. These products were noted as non-variable, and it is perceived that the characteristics of these products would not warrant insulation of specific assets from general account claims:

- Guaranteed Minimum Death Benefit – 2 in separate accounts, 1 insulated and 1 were not legally insulated.
- Guaranteed Income Benefit – 1 in separate accounts, 1 insulated and 0 were not legally insulated.
- Investment Annuity – 1 in separate accounts, 1 insulated and 0 were not legally insulated.
- Long-Term Care – 1 in separate accounts, 1 insulated and 0 were not legally insulated.

Overview of SEC Rule 151

Under Rule 151, an annuity contract issued by a state-regulated insurance company is deemed to be given a "safe harbor" from potential SEC registration if:

1) The insurer assumes the investment risk under the contract in a manner prescribed in the rule; and
2) The contract is not primarily marketed as an investment.

Under Rule 151, the insurer is deemed to assume the investment risk under an annuity if, among things:

1. The insurer for the life of the contract,
   a. Guarantees the principal amount of purchase payments and credited interest, less any deduction for sales, administrative or other expenses or charges; and
   b. Credits a specified interest rate that is at least equal to the minimum rate required by applicable state law; and
2. The insurer guarantees that the rate of the interest to be credited in excess of the guaranteed minimum rate described in 1(b) will not be modified more frequently than once per year.

(If products do not meet the safe harbor requirements, they must be assessed by the SEC for registration. If the SEC determines the product is required to be registered as an "investment" or "security", the assets supporting that product are required to be insulated in a separate account.)

Overview of SEC Rule 151A

Rule 151A (effective Jan. 12, 2011) clarifies the status under the federal securities laws of indexed annuities, under which payments to the purchaser are depending on the performance of a securities index. (This rule is applied on a prospective basis to contracts issued on or after the effective date.)

Pursuant to Rule 151A, insurance companies are exempted from filing reports under the Securities Exchange Act of 1934 with respect to indexed annuities and other securities that are registered under the Securities Act, provided that certain conditions are satisfied, including that the securities are regulated under state insurance law, the issuing insurance company and its financial condition are subject to supervision and examination by a state insurance regulator, and the securities are not publicly traded.

Under Rule 151A, indexed annuity contracts are not captured within the Rule 151 exemption for annuity contracts "if the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract". When the amounts payable by an insurer under an indexed annuity are more likely than not to exceed to amounts guaranteed under the contract, this indicates that the majority of the investment risk for the fluctuating, securities-linked portion of the return is borne by the individual purchaser, not the insurer. The individual underwrites the effect of the underlying index's performance on their contract investment and assumes the majority of the investment risk for the securities-linked returns under the contract.

Rule 151A Conclusion: If more often than not the purchaser of a fixed annuity will receive a guaranteed return like that of a traditional fixed annuity, then the instrument will be treated as insurance; on the other hand, if more often than not the purchaser will receive a return based on the value of a security, the instrument will be treated as a security. (With the latter group of indexed annuities, investors will be entitled to all the protections of the federal securities laws, including full and fair disclosure and antifraud and sales practice protections.)

***Note:* Although the SEC Rule is identified as being "final" and effective January 12, 2011, it has been identified that the US Court of Appeals for the District of Columbia vacated SEC Rule 151A. Furthermore, the Financial Services Reform conference bill was passed by the US Senate, resulting with the SEC Rule 151A being defeated by Federal Law. As a result, fixed index annuities will not be subject to SEC registration.**