

To Insulate or to Not Insulate

March 27, 2012

March 27, 2012 -- As part of the NAIC's ongoing review of general account guaranteed insurance products funded by a separate account, the Separate Account Risk (E) Working Group (SARWG) was charged to:

1. 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 Committee, including a request for Model Law Development/Change if the recommendation is for the NAIC to devote its resources to such an effort.
2. 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.

To this end, during its March 20, 2012 conference call, SARWG exposed its proposal of the characteristics for determining whether separate account assets funding an insurance product should or should not be insulated from general account liabilities. In considering what should be insulated, SARWG's initial proposal for discussion draws from FASB standards for how an entity must report separate account assets in its financial statements (ASC 944-90-25-2c and ASC 944-90-25-2d). Applying those GAAP financial reporting standards, SARWG proposes that insulation would not be permitted if a product did not satisfy the following characteristics:

1. 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.
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.

SARWG noted that the accounting standards identified certain products that do not meet the requirements for a separate account arrangement, but SARWG seeks to rely on product characteristics versus named product types to determine whether insulation would be permitted. SARWG also proposed three initial discussion points for limiting insulation to products meeting specific characteristics. Under two of the discussion points insulation should be limited: (i) to only the assets purchased with contract holder funds directly attributable to the contract holder, and (ii) to reflect that the carrier has passed through and the contract holder has assumed the investment risk of the assets purchased with contract holder funds. Finally, under the third discussion point, the goal of setting forth clear guidance on what products are legally insulated allows regulators to more clearly determine what should be exempt from state general account investment laws. During the March 20th call, commentators questioned SARWG's approach of relying on GAAP financial reporting standards for determining whether, as a matter of law, an asset should be insulated. Commentators suggested that SARWG should focus on the public policy rationale for allowing insulation and then develop criteria that furthers this public policy. One regulator noted that many products issued during the last 20-30 years that have been considered to be insulated would likely not meet the two-characteristics test proposed by SARWG. Taking into account the comments received, SARWG specifically requested:

- "information on the types of products that will be impacted if insulation is only available when [the two above] characteristics are met."
- comments "on the discussion points for limiting insulation to products meeting the specific characteristics."

SARWG requested comments by April 23, 2012. SARWG also set a schedule for future calls with the hopes that it can make a recommendation to the Financial Condition (E) Committee at the Summer NAIC National Meeting in Atlanta as to what is insulated and what products would qualify as insulated. Based on the initial comments during the March 20th call, to prevent long-standing insulated contract from becoming non-insulated, industry will need to provide comments to SARWG. We will continue to monitor this matter and provide updates.

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