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June 22, 2018

**VIA E-MAIL**

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles (E) Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

**Re: Issue: Private Placement Variable Annuities, Ref #2018-08, Interested Party Comments Due June 22, 2018**

Dear Mr. Bruggeman:

MB Schoen & Associates, Inc. and its affiliates (MBSA or we) appreciate the opportunity to comment on Private Placement Variable Annuities (Ref #2018-08). MBSA specializes in providing services to purchasers of corporate owned life insurance, commonly referred to as COLI, BOLI and/or ICOLI.[1] In aggregate, we provide comprehensive ongoing risk management support and administrative services to banks covering in excess of $18 billion of cash surrender value and have offered these and pre-purchase due diligence and placement services to banks since 1992. In addition, we've assisted leading life insurers design and develop separate account COLI and BOLI offerings.

MBSA decided to offer the comments that follow because we discerned that certain information in the "Description of Issue" is incomplete or inaccurate, and that these shortcomings may have led to certain recommendations which we believe are incompatible with the best interests of the industry. In particular, the recommendation that realizable assets should be considered non-admitted does not make economic sense. Whether, and to what extent cash surrender values of life insurance and/or annuities should be included as admitted assets is certainly among the

[1] Separate abbreviations have evolved for corporate owned life insurance, bank owned life insurance and insurer owned life insurance, in part because of different marketing approaches and/or different regulatory requirements for these segments of the market. Each of these types of owners purchase general account products or separate account products, including PPLI.

issues that should be considered, as is the appropriate determination of Risk Based Capital for insurers that own these products. However, there are important ancillary issues that should be investigated, and we therefore respectfully suggest that the Working Group postpone final recommendations until it has evaluated all of the issues, uses, risks and characteristics of these products.

Neither the NAIC nor, to our knowledge, any individual state regulator, has thoroughly investigated the use of ICOLI (and/or annuities owned by insurers). As of 3/31/2018, banks reported $191.3 billion of BOLI cash surrender value. The total BOLI reported is further categorized as follows: $88.4 billion variable or private placement separate account; $18.5 billion "hybrid" separate account; and $84.4 billion of general account (GA). BOLI plans became popular in the late 1980s and early 1990s, with annual adoption peaking in the decade leading up to the financial crisis. Consequently, banking regulators began thoroughly vetting the uses, characteristics and risk management for these products more than 20 years ago, and have published several formal sets of regulatory guidelines. The most recent of these, the "Interagency Statement on the Purchase and Risk Management of Life Insurance", was promulgated in 2004 (see OCC 2004-56). All banks, regardless of whether supervised by the OCC, FDIC or FRB are subject to identical, rigorous pre-purchase analysis requirements as well as the control framework used for the ongoing measurement and management of "BOLI" related risks. Now that ICOLI has become more popular, it is the right time for similar consideration to be given to this product.

While it is true that the regulatory frameworks for each industry differ in meaningful ways, the most essential risks and corresponding risk management and mitigation regimes for life insurance assets largely overlap. Therefore, at a minimum, we recommend that the NAIC consider the OCC 2004-56 before it finalizes its review of these products and concludes its treatment. We believe the NAIC and insurers risk significant criticism, should they hastily adopt a framework for ICOLI and annuities owned by insurers that proves to be inappropriate. This is especially true if the final rules possess obvious deficiencies when compared to those bank regulations governing the purchase, ownership and risk management of identical products (just as the banking sector would be vulnerable to criticism for adopting guidelines for bank ownership of bank originated products/assets that revealed less understanding and rigor than insurance regulators).

To be clear, we do not think the banking regulations governing BOLI are perfect as is (as elaborated upon below, we think there are areas in need of improvement) or should be emulated by the NAIC or state regulators. We just think it is unwise to ignore a rich body of research as distilled and embodied within them.

**Notes on Description of Issue**

As noted above, there are some shortcomings in the Description of Issue paragraphs. MBSA believes some of the conclusions and recommendations may have been influenced by these shortcomings, so it is important to review them. In particular, different conclusions may be reached if the inaccuracies and omissions are understood.

The third paragraph of the Description of Issue included on Form A notes that:

> Although these are referred to as PPVA, these products can be designed as Private Placement Life Insurance (PPLI) or Private Placement Variable Annuities (PPVA)

MBSA believes these two product types deserve independent consideration, because the uses and to some extent the marketplace, are quite different. In its experience, PPLI and PPVA are marketed to high net worth individuals, and PPLI (but not PPVA) is also widely marketed to corporations (including banks and insurers). Note that the tax deferral associated with deferred annuities is not available for annuity purchases by corporations (i.e., "non-natural persons"). Although deferred annuities don't enjoy the tax deferred growth treatment of life insurance products, they may, nevertheless, under certain facts and circumstances better fit a corporate buyer's needs. Accordingly, they should be evaluated based on the context to be used and its specific liquidity and risk characteristics.

The definition of "Insurance dedicated fund", or "IDF", is also contained in the third paragraph, where it is stated that:

> These products are utilized to invest in an "insurance dedicated fund" (IDF) through insurance carriers on a tax-deferred or tax-free basis. IDFs are generally alternative investment portfolios containing hedge funds, high-yield bonds, direct lending credit vehicles and high-turnover portfolios linked to variable annuity or life insurance products. Unlike traditional life insurance, an investor buys a PPLI or PPVA product principally as an income tax-free investment vehicle.

In fact, IDFs are available in registered variable life and annuity products as well as in private placement products. The distinction between registered products and private placement products is that the private placement products are exempt from registration with the SEC, with the natural result that the SEC rules applicable to private placement products are somewhat different. Among other things, the exemption from registration allows for use of non-registered investment funds within the issuing insurers' SAs, which has allowed institutionally priced managed accounts and other structures far more appealing to large corporate buyers (i.e., in lieu of registered mutual funds, which are typically priced for retail products).

Private placement plans have been defined by the Interstate Insurance Product Regulatory Commission (IIPRC). The IIPRC defines private placement plans as those "…that are issued exclusively to qualified owners, Private placement plans are available exclusively to qualified owners, as those terms are defined by the *Securities Act of 1933*, as amended, *the Investment Company Act of 1940*, as amended, or the regulations promulgated under either of those acts, and provide for benefits that vary in relation to the performance of an underlying separate account where the separate account invests in one or more funds that are exempt from registration with the Securities and Exchange Commission (SEC) under the *Investment Company Act of 1940*, as amended. Private placement plans may also offer non-exempt funds." [2]

The investments made by private placement IDFs may include the same investments that are available within registered IDFs. The vast majority of the $88.4 billion invested in SA BOLI are in traditional fixed income portfolios). MBSA maintains a SA BOLI Asset Allocation study on a quarterly basis. As of 3/31/2018, our study comprised nearly $72 billion of SA BOLI assets (~81% of the total SA BOLI assets banks reported owning). The assets were allocated as follows:

- Agency Mortgage-Backed Securities and AAA-rated ABS/CMBS: 65%
- Core Fixed Income (e.g., benchmarked to Bloomberg Barclays Agg): 23%
- Other: 12%.

Unlike registered products, private placements may also include alternative investment portfolios of the type described in the third paragraph of the Description of Issue. Some of the alternative investments include limited liquidity features, which may result in a delay before receipt of cash values. MBSA believes that the percentage of private placement plan cash values invested in alternative investments is less (maybe substantially less) than 5% of the total values.

MBSA believes that many purchasers of traditional life insurance consider the tax advantages of the product, and that the same is true for PPVA and PPLI. One tax advantage for traditional life insurance, PPLI (as well as PPVA purchased by individuals) is tax deferred growth in cash values. For traditional life insurance or for PPLI, the death benefit is tax free.

The fourth paragraph of the Description of Issue states that:

> "Information received on these products have identified that they are not dependent on an individual's health or death; however, the products can be tailored to incorporate a minimum death benefit so that it is considered a "life product" under statutory accounting."

MBSA assumes that in this paragraph, "products" refers to PPVA, because clearly the PPLI provides a significant death benefit that depends on an individual's death. Having said that, we are not aware of PPVA products where the minimum death benefit is large enough to cause the product to be considered a life product for statutory accounting. Typical minimum death benefit guarantees for PPVA products are much smaller than the benefits provided by a typical PPLI policy or other life insurance policy. MBSA is not aware of any annuity products where the annuity is appropriately treated as a "life insurance product" under statutory accounting. There are often

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[2] As defined in IIPRC-AB-03-I-PP, ADDITIONAL STANDARDS FOR PRIVATE PLACEMENT PLANS FOR INDIVIDUAL DEFERRED VARIABLE ANNUITY CONTRACTS (For use with Individual Deferred Variable Annuity Contracts)

annuity income options that can continue for life, but these life income payments are typically treated as "annuities" (perhaps for some forms as "supplementary contracts"). So, we don't fully understand this statement.

**ICOLI Uses in the Marketplace**

As detailed previously, the banking sector alone owns more than $191.3 billion in BOLI cash values. That figure does not include the amount of COLI owned by all other businesses. Bank regulations, like many state insurable interest statutes, require banks to limit BOLI purchases to amounts bearing a reasonable relationship (i.e., generally on a net present value (NPV) basis) to the employee benefit liabilities they fund (either informally, or formally). This essential business purpose must be present or the bank risks running afoul of both state insurable interest law and bank regulation, with the potential for the loss of favorable tax treatment, compulsion to surrender policies, significant headline risk and even litigation risk.

Any insurer purchasing life insurance disproportionately higher than its benefit liabilities is exposed to these same risks. However, purchases that approximate (or are less than) actuarially forecast benefits, and which conform with the notification and consent statutes of the applicable states and IRC Section 101(j), should largely mitigate, if not eliminate these risks.

Some insurer benefit liabilities, such as those stemming from defined benefit pension plans, 409A non-qualified deferred compensation plans, certain split dollar plans and other post-employment benefits (OPEBs), must be accrued during the employees' active years and are reflected as liabilities on the insurers balance sheet (and, in the case of OPEBs, since adoption of SSAP Nos. 102 and 92, this is so for both GAAP and Statutory purposes). In the case of DB Pensions and OPEBs, assets formally set aside, if they meet certain requirements, are booked as contra-liabilities, and are used to defease/offset an equivalent amount of liability (i.e., only the net liability, after taking into account the fair value of plan assets, is recorded as a liability). In the case of 409A liabilities, all funding is considered informal and "netting" against liabilities is not permitted.

Other liabilities are more informal, yet no less material. Examples include the future costs of providing medical benefits to active employees and the future costs of making matching contributions to 401(k) plans. In fact, these costs often dwarf the OPEBs when actuarially forecast and are the primary driver of bank purchases of BOLI. They are most commonly referred to as general welfare obligations (or benefits).

While some insurers have purchased ICOLI to formally fund OPEBs (e.g., within VEBAs) and to hedge 409A deferred compensation plans, many appear to use ICOLI, in similar fashion to banks, as a long term, informal means of offsetting future cash outflows attendant to continually offering various general welfare benefits to active employees.

**The Risk Based Capital Treatment of ICOLI and BOLI**

Banks are required to set aside risk-based capital for all assets on their balance sheets in highly similar fashion to that of insurers (albeit according to differing frameworks). Over a period of approximately a decade, bank regulators judiciously evaluated the attributes of separate account and general account BOLI policies, concluding, in 2004, by sanctioning distinctly divergent approaches to each. General account polices are universally subject to a 100% risk weight (which is approximately the same as holding corporate bonds and considerably higher than agency MBS, at 20%.[3] Recognizing both the insolvency insulating properties of separate accounts (i.e., in the event of the insurer's insolvency) and the fact that all credit/default risk, interest rate risk and price risk of assets held in the SA is solely borne by the policyholder, bank regulations essentially "look through" to the underlying assets of the SA for risk weighting purposes.

This is logical and has served to prevent banks from allocating to overly risky strategies (our research indicates that approximately 88% of BOLI SA assets are allocated to agency MBS securities and core fixed income).

Likewise, there should be very limited circumstances under which an insurer should be permitted to risk weight an exposure to a given class of assets (e.g., equities, hedge funds, private equity, high yield bonds) at a lower rate than a direct exposure to such assets when held in the SA of a life policy it owns. Conceivable exceptions include where exposures are immaterial, where the duration of the liability being financed is extremely long, meriting longer term, optimized strategies (like the defined benefit pension plans and OPEBs) and where the exposure, when viewed in the aggregate with other allocations, acts to reduce overall risk, e.g., as a risk reducing hedge or to reduce correlation risk.

This brings us to the crux of the current issue surrounding ownership of ICOLI/PPLI (or PPVA). The fact is that when establishing model bills governing the establishment of Separate Accounts, the NAIC was correctly focused on the risks borne by a carrier when it was acting in the capacity of the *issuer* of variable products to a large set of customers, rather than the less significant possibility that one insurer might purchase material amounts of Separate Account insurance from another insurer (thus assuming the role of policyowner, willingly bearing all the investment risks enumerated previously).

Assets held in separate accounts established by an insurer to support the non-guaranteed variable products it issues are rightly assigned an RBC rate of 0%. But, when the insurer becomes the risk bearing policyowner, this contradicts common sense. Yet, this is precisely the default outcome of the current RBC regime for life insurers. The current RBC regime was developed at a time when

[3] Now embodied under the Basel III Standardized Approach. Note that the computations may differ under the Basel III Advanced Approaches.

the amounts of ICOLI were not very significant and did not contemplate or address different categories of ICOLI.

In the event you want to consider the impact of an adverse change in RBC factors on the ICOLI or PPVA policyowners, be aware that most of these products have some operational flexibility. Most notably, policyowners with Separate Account ICOLI or PPVA values have the right to periodically reposition assets by reallocating from one or more IDFs to other IDF(s). For example, if an insurer no longer found a certain RBC requirement occasioned by its historical allocation to a sub-account invested in hedge funds, it could reallocate those funds to any number of fixed income portfolios with lower RBC requirements. However, as noted previously, this will likely take longer than typical reallocations due to liquidity restrictions imposed on these investments. Insurers should therefore be given an adequate amount of time to liquidate these positions to prevent avoidable penalties or losses. Again, lower risk weights may well be justified on the basis of encouraging both the prudent pre-funding of looming benefit liabilities and the ultra-long durational characteristics of many of these liabilities (after all, there are no risk capital costs associated with equity and alternative investments within ERISA pension plans).

The NAIC began developing its first RBC Model in 1989 and has since refined and improved it more than once (for example, the number of rating classes for corporate bonds was recently increased from 6 to 21). This thoughtfully developed framework should be taken into consideration to some degree when insurer assets are held inside SA ICOLI or annuities.

To reiterate, the pre-purchase due diligence and ongoing risk management of ICOLI should be guided by regulations commensurate with those governing BOLI. Formulating such guidelines requires further research and investigation, including thorough evaluation of banking regulations for BOLI.

Again, bank regulations are by no means a perfect proxy for ICOLI and are in need of refinement. Among other things, banking regulations have, to date, failed to provide guidance for ERISA dedicated BOLI and TOLI assets and have only permitted equity allocations representing strict, dollar for dollar hedging of certain defined contribution 409A plans (this negates prudent allocations in support of defined benefit designs).

**The Admitted Asset Status of ICOLI**

Consistent with the thinking that suggests the specific assets held within a separate account ICOLI policy should be examined to determine the appropriate risk-based capital, MBSA agrees it makes sense to look at the specific assets held to determine whether assets are admitted.

MBSA believes it makes economic sense to treat readily available, liquid assets held within separate account ICOLI or PPVA contracts as admitted assets. In accordance with GAAP, the policies are recorded at a “net realizable value.”

Rather than treating highly illiquid asset classes as inadmissible, it would likely make sense to first take into consideration whether that exposure, when viewed in the totality of the asset allocations within the ICOLI reduces overall risk (especially when the size of the alternatives/equity exposure isn't material) and the business purpose of the ICOLI (i.e., the liability's duration). Certain alternative investments might be subjected to a haircut/adjustment in recognition of illiquidity, tax upon liquidation or other risk attributes. However, it may make more sense for such supervisory disincentives to be employed through an appropriately calibrated risk-based capital charge.

In amending paragraph 6 of SSAP 21, we strongly urge you think about the underlying assets rather than whether or not the product bears investment risk. We note that it is not entirely clear what types of contracts bear investment risk. For example, while the relationship is indirect, General Account products clearly are dependent on investment results as well.

Likewise, as noted previously, whether or not a separate account product is registered should not be a primary basis for regulation. A given IDF (or investment strategy) can generally be accessed on either a registered or unregistered basis (other than strategies that may not be permissible on a registered basis).

**Conclusion**

Now that some insurers have chosen to utilize separate account ICOLI as a funding vehicle for certain significant benefit liabilities, it is appropriate to take a careful look at the issues related to PPVA and PPLI products. In particular, we recommend evaluating both the risk-based capital framework as well as whether or not the products are deemed admitted or non-admitted.

We hope these comments assist in achieving that goal. Please let us know if any clarification of our comments is desired or if we can provide additional information.

Sincerely,

Matthew B. Schoen
President

Cc: Julie Gann, NAIC staff