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Separate Accounts and Insulation

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The Minnesota Insurance Department recently issued a small, unassuming bulletin, *Number 97–6*, on guaranteed separate account contracts. The bulletin "prohibits the inclusion of a 'not chargeable' provision" in nonvariable separate account contracts issued in Minnesota. Apparently, this means that guaranteed separate account contracts cannot provide insulation from a company's general account liabilities. This bulletin has gathered a great deal of attention in some parts of the industry and deservedly so. The bulletin highlights a philosophical dilemma on the priorities of an insurance company's obligations to its policyholders that potentially could have an impact upon the entire industry.

This dilemma can best be understood within the context of the historical development of separate accounts (SAs), so first let's take a step back in time and watch the development of this often mysterious portion of the insurance company's operations.

Please be aware that this history is clearly from my vantage point as an active participant, not from that of an unbiased observer. (But then how much history is ever really written by unbiased observers?) Any factual errors are clearly inadvertent and the result of my primary desire to make a point. (Again, isn't that how history gets written?)

The Beginning of Separate Accounts

A long time ago, I believe it was a time known as the 1960s, certain enterprising insurance companies had an interesting idea. By placing policyholder funds in a segregated account with unitized values (essentially internal mutual funds), the performance of these assets could be directly passed on to the policyholder and the investment risk transferred along with it. The policyholder who was willing to bear the risk could, in turn, receive enhanced flexibility and value in return. Thus was born the variable life and variable annuity contract.

Like most wonderful, momentous, and groundbreaking ideas, it was well before its time. Except for a few market niches, variable contracts grew slowly and attracted more attention as a neat actuarial exercise than as a marketing concept.

However, the playground of the SA was created. The SA was a place where an insurance company had the freedom to create a wide range of products outside the stringent rules of the general account (GA). The only real limitation was the discretion of the regulators to approve or disapprove whatever the company produced.

The 1970s—New Money Rates versus Portfolio Rates

SAs received an unexpected boost in the late 1970s. Although variable products had not yet caught on, interest rates were steadily moving upward. New upstart companies began aggressively attracting money by offering new money interest rates. In a staid, conservative industry in which consistent, steady portfolio rates were the norm, this caused quite an upheaval.

To attract the big money (like pension plan assets), it became increasingly necessary to be able to pass on the current higher interest rates directly to these policyholders. But how could this be done without disadvantaging the other GA policyholders? (Remember GA segmentation was not yet a part of business or even legal in many jurisdictions.)

Oh yeah, the SA! Many enterprising companies discovered they could segregate the new money coming in on large pension contracts and pass the benefits of new money rates directly on to the policyholder. These SAs looked different than variable accounts—they were not unitized and often used book-value accounting—but that was the beauty of the SA. It provided the flexibility to be responsive to market needs while the GA rules caught up with market desires.

The 1980s—New Products

The 1980s brought new products and new challenges to the staid, conservative insurance industry. Tax law changes and capital concerns caused many companies to look closely at reserving practices. Continuing high interest rate levels led to a proliferation of new GA products that credited current interest rates.

SPDAs and universal life spread forth across the industry bearing healthy fruit and multiplying. These contracts were structured around a simple concept—a policyholder fund or account value to which premiums and interest are credited and expense, benefit and risk charges taken.

At their birth, little thought was given to reserving. It seemed obvious that the account value represented the most reasonable reserve. But then came tax law changes and capital concerns. Once again those enterprising insurance companies sat back and realized that the account value was not a true measure of the company's liability to the policyholder but merely a step in an actuarial calculation or in a policyholder statement (depending on your point of view). There was no rational reason not to apply CRVM or CARVM reserve methodologies to those products and hold more appropriate reserves. As a matter of fact, the new tax law requires that this calculation be done for tax reporting. By the end of the 1980s, all but a few companies were directly calculating CRVM or CARVM reserves on GA account value-driven products. These resulting reserves often fell much closer to the cash-surrender value than to the account value.

Something else started to happen in the 1980s, although it went unnoticed by many. Variable contracts started to come of age. At this point it was more of a quiet, nonviolent resistance compared to the massive armed revolution going on in the GA. But the movement was there, quietly growing. As this growth began, it became apparent that these variable contracts had much in common with GA account value-driven products. The SA rules said reserves should be consistent with those applied to the GA. Although the SA assets had traditionally been thought of as policyholder assets, the policyholder was currently entitled only to the cash-surrender value and whatever future benefits the policy mechanics generated. The variable contract account value was no better a measure of the policy liability than its GA counterpart. Various methodologies were developed to calculate reserves for variable products, some good and some not so good.

The 1980s also saw a continuing variety of new product innovations that were fueled by the flexibility of the SA rules. Among these were products that lent themselves to market-value accounting techniques and were placed in new separate accounts as much to utilize alternative accounting as to segregate assets. (Modified guaranteed annuities are a personal favorite of mine in this category.)

The 1990s—The Big Bang

The 1990s brought moderating interest rates, a booming stock market, and the flight to quality and security.

Finally, after all those years and after virtually all the bright, innovative persons who wrote the rules that created separate accounts are off in retirement, the bright, innovative idea of variable products has come of age. Variable life and annuity products abound and proliferate daily. At the same time, new uses and new twists on old uses of SAs also grow.

As the importance of variable products has grown, reserving techniques have developed. Although the legal requirements have not been actively clarified, industry practice has centered around a reasonable methodology of reserving that recognizes that the policyholder liability is often less than the full account value. Accounting conventions and risk-based capital rules have also been adjusted to recognize that the excess of the SA funds over policyholder liabilities is a legitimate asset of the GA, available to benefit the company and its GA policyholder.

While variable products have grown drastically, so have a wide variety of other nonvariable SA products. These products run the gamut of size and policy features with a full range of guarantees and experience pass-throughs available.

The Dilemma—Categorizing Separate Accounts

As these nonvariable SA products have flourished, our philosophical dilemma has arisen. In a simple world, *nonvariable* SA products would fall into two categories. One group would include those in which policyholder funds (often those from one big policyholder) have been separated from the GA so that the performance of those funds would be passed directly on to the policyholder. Often these would be insulated from any GA liabilities, but *no guarantees of investment performance would be granted from the GA*. Mortality guarantees would generally be purchased from the general account, but investment risk would be borne entirely by the policyholder.

The second group would include policyholder funds that have been separated from the GA to allow for tracking of specific performance and/or alternative accounting treatment. These SAs would include investment performance guarantees that would be backed by the GA, but there would be no insulation of the SA assets from GA liabilities. In essence, the SA would be little more than an accounting convention for the company that had little relevance to the policyholder.

Unfortunately the real world is not that simple. The flexibility of the SA laws allows the possibility of a full range of products on the spectrum between the two in my simple philosophically pure world. The regulatory structure allows a block of policies to be segregated in a SA with substantial investment guarantees made to the corresponding policyholders. It also allows the option for the company to insulate these assets from the remaining GA liabilities while at the same time requiring assets to be maintained in the SA sufficient to fund the liabilities. The result is, in essence, a preferred class of policyholders who have their assets protected from GA liabilities while having first call on GA assets.

Outside competitive forces are serving to fuel the proliferation of these contract types as policyholders, big and small, realize that this type of contract provides an added layer of protection beyond the traditional GA product. Simply put, everybody likes being a preferred class of policyholders.

The philosophical dilemma in this real world is a troubling one. Is it appropriate to create preferred classes of policyholders in SAs? If the GA policyholders are taking a secondary status to these SAs, is the commitment to the SAs adequately reflected on the company's books?

The Minnesota Bulletin answers these questions clearly and succinctly. No, preferred classes of policyholders are not appropriate. I applaud Minnesota's efforts and hope it is a first step towards moving us into my simple world where assets can be insulated only to the extent the policyholder bears the full risk of the performance of those assets and any guarantee beyond this stands in line with the rest of the GA policyholders. In other words, a world where these preferred classes of policyholders cannot be created at the potential detriment of others.