Financial Security. For Life.

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July 22, 2011

Mr. David A. Stawick
Secretary, Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Ms. Elizabeth M. Murphy
Secretary, Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-16-11
Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping

Dear Mr. Stawick and Ms. Murphy:

The American Council of Life Insurers ("ACLI") is a national trade association with 300 members that represent more than 90 percent of the assets and premiums of the life insurance and annuity industry. Life insurers actively participated in the legislative dialogue concerning regulation of derivatives markets and have provided constructive input on proposed rulemaking implementing Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

The ACLI respectfully submits the following comments in response to the notice of joint proposed rules ("proposed rules") and interpretations ("proposed interpretive guidance") to implement the Dodd-Frank Act by the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC" and, together with the CFTC, the "Commissions") on Product Definitions Contained in the Dodd-Frank Act.[1] We strongly support the Dodd-Frank Act's legislative goals of systemic risk reduction and transparency in the derivatives markets. Further, we absolutely agree with the Commissions' position that products historically treated as insurance should not be included within the swap or security-based swap definitions.[2] We also applaud the Commissions' attempt, through the proposed rules and interpretive guidance, to clarify that

1 Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, Release No. 33-9204, 34-64372, 76 Fed. Reg. 29818, 29821 (May 23, 2011).

2 Id. at 29821-29822.

agreements, contracts, or transactions meeting certain criteria would be considered insurance and not swaps or security-based swaps (the "Proposed Exclusion"). However, as more particularly described in this letter and as discussed in a comment letter submitted today (the "CAI Letter") on behalf of the Committee of Annuity Insurers ("CAI"), we continue to be concerned that the orientation and framework of the Proposed Exclusion will apply poorly to many common insurance and reinsurance products and transactions and will result in unnecessary conflict and confusion.

Background and Request for Reconsideration of Original ACLI Approach

Although nothing in Title VII or its legislative history suggests that Congress intended to regulate insurance as swaps, some commentators expressed concern that the statutory definition of "swap" is, in fact, broad enough to encompass insurance.[3] In an effort to address this concern, the ACLI offered a functional approach (the "Original ACLI Approach") to the scope and definition of swap, and its potential application to insurance and annuity products, that was intended to provide legal certainty in the insurance marketplace.[4] We continue to believe that the proper test of what is "insurance" should be premised on state-level authorization and regulation of insurance products and life insurers. This approach is consistent with the existing regulatory scheme for insurance and with the requirements of the McCarran-Ferguson Act limiting the authority of the federal government to regulate the business of insurance.[5]

Moreover, because regulation of insurance is fundamentally a matter of state law, there is no universally-accepted definition of the term. We have attached, as Appendix 2, a 2006 report from the Government Accountability Office ("GAO") entitled "Definitions of Insurance" which reflects the absence of a universally accepted definition of insurance after surveying state insurance law, federal law definitions of insurance, and accounting and actuarial guidance. The GAO paper reports finding elements which were common to the various definitions, including "risk transfer and risk spreading;" "indemnification, which is the payment for losses actually incurred;" "the ability to make reasonable estimates of future losses;" "the ability to express losses in definite monetary amounts;" and "the possibility of adverse, random events occurring outside the control of the insured." Despite these relatively common components, no comprehensive definition has been widely accepted. We believe that any attempt to develop such a universally-accepted definition of insurance, particularly in the context of a sweeping reform of the derivatives markets, is certainly destined to be either over-inclusive or under-inclusive and to add unnecessary confusion and

[3] Letter of Cleary Gottlieb Steen & Hamilton, dated September 21, 2010 at http://sec.gov/comments/s7-16-10/s71610-63.pdf. See also, letter of the National Association of Insurance Commissioners, dated September 20, 2010, at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26206&SearchText=NAIC.

[4] A copy of the ACLI's letter proposing the Original ACLI Approach is attached as Appendix 1. The CAI filed a letter shortly thereafter supporting ACLI's position and offering additional analysis and reasoning; a copy of this submission is available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=42624&SearchText=. This approach to excluding an insurance contract or transaction from the definitions of swap and security-based swap is based on a three part test. First, the contract must be issued by an insurance company and subject to state insurance regulation. Second, the contract must be type of contract issued by insurance companies. Third, the insurance contract must not be a type of contract that the CFTC or the SEC wishes to regulate.

[5] "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance … unless such Act specifically relates to the business of insurance. " 15 U.S.C. § 1012(b) (emphasis added).

uncertainty to this already complex reform initiative. Consequently, we join with the CAI in requesting that the Commissions reconsider the Original ACLI Approach, also endorsed by the CAI, as the appropriate framework for excluding insurance products from the swap definitions under Title VII.[6]

Analysis of the Proposed Exclusion

Even if the Commissions decline to adopt the Original ACLI Approach, we believe that the Proposed Exclusion in its current form is unworkable when applied in the context of life and annuity products. Although we appreciate the obvious consideration of the Original ACLI Approach by the Commissions, and we recognize that portions of the functional analysis offered by the Original ACLI Approach appear in the proposed interpretive guidance, the Proposed Exclusion nevertheless creates a presumption and implementing framework that do not adequately address many insurance and reinsurance products and transactions. A thoughtful and comprehensive discussion of these issues is presented in the CAI Letter, which the ACLI is pleased to endorse. Rather than repeating that complete analysis here, we will summarize and specifically identify the ACLI's fundamental concerns with the Proposed Exclusion, which we believe to be entirely consistent with the approach taken by the CAI.

1. <u>The Proposed Exclusion Begins with an Incorrect Presumption</u>. The proposed interpretive guidance, as discussed above, recites the absence of Congressional intent to include insurance products within the definition of "swap." We are concerned, nevertheless, that it appears to start with the presumption that insurance products are, in fact, swaps regulated by Title VII unless they satisfy the Proposed Exclusion. We believe that the operative presumption should be that insurance products are not swaps. We ask the Commissions to provide clarification to this effect, as reflected in footnote 28 of the proposed interpretive guidance.[7]

2. <u>The ACLI Supports Inclusion of an "Issuer Component" to the Proposed Exclusion</u>. The Original ACLI Approach suggests that the most fundamental component of an insurance product exclusion is that the product under consideration must be issued by an insurance company in respect of which the sale, reserving, payment or performance of such agreement, contract or transaction is subject to supervision by an insurance commissioner or similar official or agency of a state. We continue to believe that state regulation of the issuer is a critical consideration in distinguishing a swap from insurance.

   However, as the proposed rulemaking has developed, we have developed a concern that the Proposed Exclusion could permit a company ***other than*** an insurance company to intentionally "fail" this component of the test and issue products that clearly should be regulated as insurance under the guise of a swap. It should not be possible for a company to avoid state-based regulation of insurance by exploiting this definition to structure

[6] As noted in the discussion appearing in paragraph 2 below, we do believe that the Original ACLI Approach should be modified to reflect that a company other than an insurance company should not be able to issue insurance products in the guise of swaps by intentionally failing the issuer component of the Proposed Exclusion.

[7] 76 Fed. Reg. at 29822.

insurance products as swaps and offer them through non-insurance companies. We believe this can be addressed by modifying the issuer test to be satisfied if a person is ***or is "required to be"*** organized as an insurance company, rather than being satisfied only if the person "is" organized as such. This is consistent with the overarching policy that the exclusion be based on state-level regulation of insurers and insurance products.[8]

3. <u>The Annuity Component of the Proposed Exclusion is Unnecessarily Restrictive</u>. We believe it is essential that any final rule not condition the exclusion for annuities on their tax treatment under Section 72 of the Internal Revenue Code. This characterization is not relevant to any policy for swap determination and would cause many common annuity products, including those purchased by or in connection with individual retirement accounts and 401(k) plans, to fall outside of the exclusion. We believe that eligibility for a tax deferral of any "inside build-up" of income associated with the annuity product is irrelevant in the determination of whether a product is a swap. We believe that the Commissions' final rules should reflect that annuities subject to state regulation are not swaps, without reference to their characterization under the tax code, which does not provide a useful basis for distinction. Moreover, in so doing, we believe the Commissions should confirm that other types of annuity and pension plan products, such as guaranteed investment contracts, funding agreements, structured settlements, deposit administration contracts, and immediate participation guarantee contracts, all of which have long been used by insurance companies in retirement plan and other institutional markets, are within the Proposed Exclusion.[9]

4. <u>The Product Component of the Proposed Exclusion, Although Perhaps Appropriate for Other Kinds of Insurance, is Ill-fitting when Considered in the Context of Life Insurance and Annuity Products</u>. The Proposed Exclusion contemplates that a product (other than financial guaranty insurance) will be characterized as insurance if it satisfies the following criteria:

    a. It requires the beneficiary of the agreement to have an insurable interest that is the subject of the agreement and to carry the risk of loss with respect to that interest continuously throughout the duration of the agreement;

    b. It requires loss to occur and to be proved, and that any payment or indemnification be limited to the value of the insurable interest; and

    c. It is not traded, separately from the insured interest, on an organized market or over-the-counter.

    These requirements may be suitable for many property and casualty insurance contracts, and they provide a thoughtful framework in which to distinguish credit default swaps from insurance. Nevertheless, their application in the context of most life and annuity products is troublesome. As the following discussion reflects, application of these requirements to

[8] We therefore submit, in response to the Commissions' Request for Comment number 12, 76 Fed. Reg. at 29826, that an "Issuer Component" is useful in determining whether a product should be characterized as insurance or as a swap.

[9] The discussion at footnote 20 of the CAI Letter is particularly instructive on this point. Similarly, pursuant to Section 719(d) of Dodd-Frank, stable value contracts are not currently characterized as swaps and will be the subject of a separate study expected to be released in the coming months.

many insurance and annuity products that undoubtedly should remain subject to state regulation would likely cause them to fail for qualification under the Proposed Exclusion and subject them to regulation under Title VII.

Insurable Interest and Risk of Loss

Insurable interest is a general requirement under state insurance law for many types of insurance, but not for annuity contracts or reinsurance agreements. In addition, insurable interest is a creature of state insurance law and case law and does not have a uniform definition among U.S. jurisdictions. Therefore, determining whether the beneficiary of an agreement has an "insurable interest" would require the Commissions to analyze state insurance statutory and case law as well as determine which jurisdiction's law should apply.

For life insurance, state insurance law does uniformly require that the beneficiary (or applicant) have an insurable interest in the insured, but only at the inception of the policy. It is quite common for life insurance policy owners to sell their policies to unrelated third parties, if and when the financial circumstances that prompted the initial purchase of the policy have lapsed. Such transactions are generally recognized and permitted under state insurance law (and subject to "transfer for value" recognition of gain under I.R.C. § 101(a)(2)). However, the beneficiary in such cases would no longer have an insurable interest in the "subject of the agreement" in the traditional sense. Such transactions would therefore appear to violate the requirement that the beneficiary "carry the risk of loss with respect to that interest continuously throughout the duration of the agreement." Similarly, a life insurance policy on a spouse may continue in effect after divorce, and a key person insurance policy could continue in effect following a termination of employment, notwithstanding that the insurable interest may be eliminated or have changed.

In addition, for life insurance, most states' insurable interest laws do not declare a policy lacking insurable interest as void. Only in the minority of states which void a policy procured in violation of the insurable interest law is it clear that the insurer may interpose lack of insurable interest as a defense to non-payment. Therefore, in most states, a conventional life insurance policy does not "by its terms or by law, as a condition of performance, require the beneficiary of the agreement to have an insurable interest that is the subject of the agreement."[10]

Requirement that Loss Occur and Be Proved, and that Payment be Limited to the Value of the Loss

Annuity products, in particular, simply do not provide indemnity for a loss, but instead are generally designed to provide an income stream subject to the terms of the contract. Consequently, the loss component of the Proposed Exclusion is especially ill-fitting in this context.

[10] For these reasons, we believe in response to the Commissions' Request for Comment number 4, 76 Fed. Reg. at 29825, that the insurable interest and risk of loss requirements are not useful in distinguishing life insurance and annuities from swaps or security-based swaps.

Additionally, we are aware of reinsurance transactions where “modeled” losses have been substituted as a proxy for actual loss. For example, in certain transactions, the parties may agree that a hurricane reported by the National Weather Service as impacting a certain defined area at or greater than a certain defined wind speed would trigger a defined payment from the reinsurer to the insurer. We understand that state insurance departments have approved such transactions for reinsurance treatment based on actuarial certifications that such “modeled” losses were expected to closely approximate actual losses. Imposition of the Proposed Exclusion as written would remove such transactions from the regulatory purview of state insurance departments and subject them to regulation by the Commissions. In addition, it would throw into question direct insurers’ consideration of such types of loss triggers for their policies.

Moreover, benefits payable under ordinary life insurance policies are not constrained by the “value” of the life of the insured. Similarly, long-term care and disability insurance may or may not be limited by the value of any insurable interest; yet we believe no one would suggest that this feature removes them from characterization as insurance and should instead cause them to be regulated as swaps.[11]

<u>Requirement that the Product is Not Traded, Separately from the Insured Interest, on an Organized Market or Over-the-Counter.</u>

Many conventional insurance products, particularly annuities, can be assigned by the owner, and often state insurance law requires such assignability as a condition for approval of the product for sale under applicable insurance law. Insurance policies are frequently assigned among family members, to third parties as collateral for loans, and in a host of other situations. We believe that none of these entirely common kinds of assignment should cause an insurance product to be characterized as a swap.[12]

<u>Consideration of an Additional Requirement: Product Not Based on a Price, Rate or Level</u>

The Commissions specifically seek comment[13] on whether the product component of the Proposed Exclusion should require that, in order to avoid characterization as a swap, a product must not be based on the price, rate, or level of a financial instrument, asset, or interest or any commodity. Several categories of conventional insurance products are, or could be interpreted as being, based on, or related to, a price, rate or level of a financial asset. Examples include registered and unregistered variable annuities and variable life insurance, and certain fixed annuities and equity indexed annuities. These types of products provide life insurance or retirement benefits, and are not entered into for speculative purposes. Moreover, such products have been subject to extensive state insurance

[11] Accordingly, in response to the Commissions’ Request for Comment number 5, 76 Fed. Reg. at 29825, we do not believe that the loss occurrence and benefit limitation components of the Proposed Exclusion are useful in distinguishing life insurance and annuities from swaps or security-based swaps.

[12] For these reasons, we believe in response to the Commissions’ Request for Comment number 2, 76 Fed. Reg. at 29825, that the proposed criteria for distinguishing insurance from swaps or security-based swaps are not appropriately encompassing and are unworkable as applied to life and annuity products.

[13] Request for Comment number 7, 76 Fed. Reg. at 29825.

regulation and in some cases federal securities regulation, long prior to the enactment of Dodd-Frank.

This test simply would not be workable for many variable life insurance and annuity products that provide minimum death benefit guarantees or guaranteed minimum withdrawal benefits that vary with the performance of specified assets. In addition, such a requirement would be inconsistent with common replacement value property and casualty insurance, where the insurer's payment obligation may be based on the current price of the insured property or adjusted to reflect inflation. Further, this requirement would not be workable for other types of insurance policies, such as crop insurance policies, which could reasonably call for payment to be based in some way on the market price of the covered crop on the date of loss. In addition, pricing actuaries for financial guaranty insurance could reasonably base the premium on the price of a reference entity's bonds. These are just a few examples of why the "price, rate or level of a financial instrument, asset or interest or any commodity" criterion is not an effective criterion in distinguishing insurance from swaps and security-based swaps.

<u>Consideration of an Additional Requirement: Other Criteria Useful in Distinguishing Insurance from Swaps</u>

In response to the Commissions’ specific request for identification of additional criteria that may be useful in distinguishing insurance from swaps,[14] we concur with the CAI that, to the extent the Commissions are compelled to include a distinct Product Component in the Proposed Exclusion, that component should exclude products to which Section 3(a)(8) of the Securities Act of 1933 is applicable, as well as insurance products that are also securities. As the CAI points out in its extensive discussion,[15] the law in this area is well-developed and potentially well-suited to application in the context of distinguishing insurance and annuities from swaps.

5. <u>The Proposed Exclusion Does Not Adequately Address Reinsurance Agreements</u>. In the joint notice describing the Proposed Exclusion, the Commissions explained that “. . . where an agreement, contract, or transaction qualifies as insurance excluded from the swap and security-based swap definitions, the lawful reinsurance of that agreement, contract, or transaction similarly should be excluded” and that “[s]uch reinsurance would be excluded . . . even if the reinsurer is located abroad and is not state or Federally regulated.”[16] This approach is very constructive and would encompass many, but not nearly all, reinsurance transactions. As described below, however, the Proposed Exclusion fails to implement this intended approach. Moreover, this intended approach to reinsurance does not address US-based companies reinsuring non-US insurance companies and risks.

[14] Request for Comment number 15, 76 Fed. Reg. at 29826. This discussion appears at pages 23-25 of the CAI Letter.

[15] CAI Letter at pages 25-26.

[16] 76 Fed. Reg. at 29825.

The Product Component of the Proposed Exclusions does not Include Reinsurance Agreements or Transactions.

The Issuer Component of the Proposed Exclusion includes in its scope state and federally regulated reinsurers and certain non-US (i.e., alien) reinsurers. To satisfy the Proposed Exclusion, however, the reinsurance transaction must also fall within the Product Component of either the proposed rules or proposed interpretive guidance. Neither includes any express reference to reinsurance products or transactions. In addition, insurable interest requirements under state insurance law generally do not apply to reinsurance transactions,[17] and therefore most reinsurance agreements will not directly satisfy the multi-part Product Component of the proposed rules. As a result, reinsurance agreements do not appear to fall within the Proposed Exclusion. Given the widespread use of reinsurance, this omission is greatly troublesome.

The Intended Approach to Reinsurance does not Encompass US-Based Insurers Reinsuring Non-US Insurance Companies.

Reinsurance is increasingly a global business. The Proposed Exclusion, even if modified to implement the intended approach referenced above, would not account for US-based companies providing reinsurance coverage to non-US insurance companies insuring non-US insurance risks. Because a non-US insurer and its underlying transactions are not subject to state or federal insurance regulation, the reinsurance of that risk by a US company would not be within the scope of the Proposed Exclusion. This result is inconsistent with the extensive and global nature of reinsurance markets, and consequently we believe that state insurance or federal regulation of the underlying insurance company and product should not be required for a reinsurance transaction to avoid characterization as a swap. It should also be recognized that reinsurance is commonly provided to other reinsurers as well (i.e., retrocession) and such second or subsequent level(s) of reinsurance (or, generally, reinsurance provided in a chain of reinsurance) should not be characterized as a swap. Retrocession is common in the global reinsurance market to spread risks among many insurers, and its use should not be complicated by the intervention of Title VII.

We believe that the final exclusion must unequivocally provide that it is available to both domestic and offshore reinsurers for any reinsurance product or transaction as to which the risk reinsured is appropriately characterized as insurance, either in the United States or in the home jurisdiction of the reinsurer's clients.

6. The Proposed Exclusion is Insufficiently Clear in its Application to both Swaps and Security-based Swaps. In its current form, the Proposed Exclusion arguably is not clear in its application to the definition of security-based swap as well as the definition of swap. This ambiguity should be resolved to make clear that a product within the final exclusion is neither swap nor security-based swap.

[17] Reinsurance transactions generally are regulated through an insurer's certificate of authority or licenses with respect to permitted lines of business, requirements for indemnity and risk transfer, and accounting standards governing credit for reinsurance on an insurer's statutory financial statements.

7. The Proposed Rule Itself Should be Expanded to Include the Products Covered by the Proposed Interpretive Guidance. In order to provide certainty about the legal status of the proposed "interpretive guidance," such guidance should be characterized as a non-exclusive safe harbor forming part of the proposed rule. We believe the discussion at pages 23-27 of the CAI Letter is particularly persuasive in this regard.[18]

Proposed Resolution

ACLI respectfully submits that the foregoing analysis supports the proposition that the Product Component embodied in the Proposed Exclusion is unworkable for a wide range of life insurance and annuity products. The ACLI further submits that, given the absence of any universally-recognized definition of insurance, the inclusion of any Product Component in the context of Title VII, as to which insurance products are quite simply out of scope, is inappropriate (except to the extent that the exclusion would require the product to be regulated under state insurance law). ACLI reiterates the position that the Original ACLI Approach (modified to prohibit non-insurance companies from issuing insurance products as discussed above) provides a more sound approach for dealing with insurance products in the context of Title VII.[19]

If the Commissions are unable to share in this conclusion, then ACLI endorses the proposed resolution developed by CAI. Accordingly:

1. The Proposed Exclusion should be reworked to begin with the presumption that products subject to regulation under state insurance law should be regulated as such and not as swaps.

2. The Issuer Component of the Proposed Exclusion should prohibit companies that are not regulated as insurers from issuing insurance products under the guise of swaps.

3. The Product Component of the Proposed Exclusion should be modified as follows:

    a. Annuities should receive the benefit of the exclusion without regard to status under Section 72 of the Internal Revenue Code. ACLI submits that tax treatment is not a meaningful basis on which to distinguish a swap from insurance, and that the formulation in the Gramm-Leach- Bliley Act designed to differentiate products banks

[18] If the Commissions are reluctant to embody the entire insurance product exclusion within the body of the rule, we would request that the rule contain a specific reference to and endorsement of the interpretive guidance so there can be no doubt, for example, that a life insurance policy excluded from the definition of swap by the interpretive guidance would not be subject to characterization as swap because it fails the "insurable interest" or "benefit limitation" component of the final rule.

[19] We understand that the Commissions may be concerned that a state might theoretically allow regulated life insurers to issue products that are swaps under the guise of insurance and circumvent the requirements of Title VII. The express language of Section 721(a) (47)(A)(iii) of the Dodd-Frank Act specifically provides that anything that is or in the future commonly becomes known as any of the enumerated products, including credit default swaps, is subject to regulation under Title VII. Moreover, Section 722(h) specifically provides that any swap so enumerated cannot be regulated as insurance. Accordingly, we view such an eventuality to be unlikely, as it appears to be inconsistent with the express requirements of the statute. In such a hypothetical case, we believe that a regulated insurance company attempting to sell swaps disguised as insurance could well find itself in the untenable position of materially violating both state and federal law.

can sell from those that insurance companies can sell is not useful in distinguishing insurance from swaps.

b. The Proposed Exclusion should be expanded to include products qualifying for the section 3(a)(8) exclusion under the Securities Act of 1933, as well as those insurance products that are characterized as securities.[20]

c. All aspects of the Proposed Exclusion should be embodied in the final rule, as opposed to interpretive guidance. Moreover, the exclusion in its final form should be characterized as a "safe harbor" only, and no inference should be drawn or conclusion compelled that products falling outside the exclusion are necessarily characterized as swaps or security-based swaps. This "safe harbor" approach can easily be modeled after the safe harbor approach used by the SEC in adopting Rule 151 under section 3(a)(8) of the 1933 Act. A safe harbor approach regarding section 3(a)(8) also has precedent in section 989J of the Dodd-Frank Act. The characterization as a "safe harbor" is especially critical to the extent that the Proposed Exclusion includes an enumeration of excluded products or embodies concepts such as "insurable interest," "loss occurrence," and "benefit limitation," as these concepts are ill-fitting in the context of many conventional life insurance and annuity products.

d. No additional limitation should be imposed on products tied to the price, rate or level of any instrument or asset.

e. To the extent the Commissions deem it desirable, we believe it would be appropriate, as suggested in the Original ACLI Approach, that the final rule contain a "fail safe" provision allowing the Commissions to determine after notice and hearing that specified products should be characterized as swaps and not as insurance.

4. The Product Component of the proposed rules and proposed interpretive guidance should be modified to expressly include reinsurance and retrocession transactions, and should be expanded to include reinsurance and retrocession of insurance risks ceded by non-US insurance companies to US insurance companies.

5. The Proposed Exclusion should be clear in its application to both swaps and security-based swaps.

6. Finally, in response to the Commissions' specific request for comment on whether a "grandfathering" provision would be appropriate with respect to the Proposed Exclusion, we agree that it would.[21] We believe it is necessary for the final rule to include a grandfather provision providing that any type of product regulated as insurance before July 21, 2010, be considered insurance and not fall in the swap definition. This product-based grandfather provision would reduce confusion and uncertainty that would arise in applying the swap

[20] The proposed interpretive guidance acknowledges that insurance products that are securities would not be regulated as swaps under Title VII. 76 Fed. Reg. at 29822, footnote 31.

[21] Request for Comment number 20, 76 Fed. Reg. at 29827. Although we believe that a grandfathering provision is appropriate, we do not believe that such a provision in itself will address all of the shortcomings we have identified in the Proposed Exclusion as applied to insurance and annuity contracts.

definition to products historically regulated as insurance products, while also addressing the Commissions' stated concern about contracts that are swaps being intentionally characterized as insurance products to evade the regulatory regime under Title VII. Products regulated as insurance prior to the Dodd-Frank Act becoming law clearly were not characterized as insurance to avoid the new regulatory regime for derivatives.

In addition to a product-based grandfather provision, we believe it is necessary to include an effective-date-based grandfather provision in the final rule, which provides that any contract or transaction subject to state insurance regulation and entered into prior to the effective date of any final rules necessary to implement Title VII, including rules further defining swaps, shall not fall within the swap definition. An effective-date-based grandfather provision is needed to address the continuous nature of product development and innovation in the insurance marketplace. In other words, it may not be clear if a product-based grandfather provision alone would encompass all product variations and development occurring after the Dodd-Frank Act was adopted and before final rules are effective. Some of this product development may be adequately addressed by the final insurance product exclusion set forth in the final rule, but until the rule is final and adopted there will be uncertainly about its scope and coverage. Transactions executed and regulated as insurance before any final rule is in place must be grandfathered to address this concern.

Conclusion

The ACLI greatly appreciates the continuing opportunity to offer feedback in connection with this critical component of the Title VII rulemaking, which potentially has enormous significance for our members and for the millions of Americans who rely on their products in planning their financial futures. Please let me know if you have any questions or if there is additional information we can provide to assist the Commissions in the formulation of the final rule on this subject.

Sincerely,

Carl B. Wilkerson

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CC: Julian E. Hammar, Assistant General Counsel, CFTC Office of General Counsel
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Appendix 1: ACLI 11.12.10 Letter

ACLI
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November 12, 2010

Mr. Julian Hammar, Assistant General Counsel
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Re: Clarifying the Status of Insurance Products under the Definition of "Swap" in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Mr. Hammar:

ACLI greatly appreciates the courtesy of your CFTC and SEC colleagues to meet with representatives of the life insurance industry on November 8, 2010, to discuss the definition of the terms "Major Swap Participant," "Major Security-Based Swap Participant," "Swap," and "Security-Based Swap." The dialog was constructive and informative.

During the meeting, CFTC staff indicated that it would be helpful for ACLI to address the status of insurance products under the definitions of Swap and Security-Based Swap in writing. In an effort to respond promptly to the suggestion, we quickly convened our policy groups and developed the material below as a preliminary endeavor. We would be happy to discuss this letter further with the CFTC or SEC staff, and to answer any questions that may develop.

I. Need for Clarification

The Dodd-Frank Act includes within clause (A)(ii) of the swap definition any contracts that "provides for any purchase, sale, payment, or delivery . . . that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence."[1]

Nothing occurred during countless meetings with Congressional staff and others during the lengthy process leading up to the adoption of the Act that ever suggested Congressional intent to regulate insurance products.[2] The specific terms used in the above-quoted swap definition, in the eyes of

[1] Dodd-Frank Act Section 721(a)(47).
[2] In fashioning the Federal Insurance Office, for example, Congress was careful to make sure that the Office had no general supervisory or regulatory authority over the business of insurance. The CFTC or the SEC should not use the intentionally broad term "swap" under the Dodd-Frank Act Title VII as an indirect means to regulate insurance, an authority that was expressly denied in Dodd-Frank Act Title V.

some observers[3], have injected a degree of uncertainty concerning the application of Congress's intentionally broad swap definition to life insurance products.

Moreover, the Act's very clear preemption of the authority of states to regulate swaps as insurance further increases the demand for clarity.[4] Any traditional insurance contract offered by an insurer that falls on the swap-side of the dividing line will fall out of the state regulatory scheme and come under the Commissions' regulations, and could be deemed as an unlawful non-insurance contract for an insurer to offer in the first instance, even assuming that the swap complied with federal law.[5] In short, it is important to eliminate any potential suggestion that traditional, decades-old forms of insurance that fulfill consumer demands for financial and retirement security may unreasonably be exposed to unclear legal status.

To achieve legal certainty and avoid unnecessary disruption to a broad range of insurance products, we recommend that the CFTC and the SEC issue parallel guidance aimed at clarifying the scope of the swap definition. Such guidance should draw a more explicit line between swaps, on the one hand, and insurance, on the other. The potential disruption to the traditional insurance marketplace posed by an unclear application of the swap definition warrants interpretive clarification or rulemaking to prevent disruption of the insurance marketplace.[6] We do not believe Congress intended to provoke a disruption to the marketplace for insurance products. The proper test of what is "insurance" should be premised on state-level authorization and regulation of insurance products and life insurers.[7]

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[3] Letter of Cleary Gottlieb Steen & Hamilton, dated September 21, 2010 at http://sec.gov/comments/s7-16-10/s71610-63.pdf .

[4] Dodd-Frank Act Section 722(b). States may be inclined to amend their insurance laws to define the permissible kinds of insurance that may be transacted by an insurer to exclude any contracts that are determined to be federally regulated swaps. This would be necessary given the core functions of insurance regulators to supervise the solvency of insurance companies and determine the sufficiency of assets supporting insurance company contract obligations, which would be impossible with preemption of state insurance law for these products.

[5] State insurance laws often regulate the kinds of derivative instruments that an insurer may use and the specific derivative transactions with which they may be used. New York Insurance Law Section 1410 (with applicable definitions found in Section 1401(a)) is illustrative, especially since New York imposes its derivative regulation on not just New York domestic insurers but all insurers licensed to do insurance business in New York. Under New York law, a "swap" is a permitted derivative instrument (Section 1401(a)(7)), but it can only be used in a hedging transaction (Section 1401(a)(12)), a replication transaction (Section 1401(a)(18)) or limited kinds of income generation transactions (see Sections 1410(c), 1410(l) and 1410(d), respectively). Sale of an insurance policy or annuity would constitute none of these permissible kinds of derivative transactions, and therefore it would not be an authorized use of derivatives for life insurers under New York law.

[6] The preemption was specifically designed to preclude the opportunity for state legislatures to regulate the issuance of credit default swap as financial guarantee insurance subject to state insurance laws. The development that precipitated Congressional concern was a model law developed by the National Conference of Insurance Legislators (NCOIL), to regulate the issuance of credit default swap as financial guarantee insurance subject to state insurance laws. Congress wanted to prevent expansion of states' jurisdiction over the issuance of CDS, but did not act to cut back on existing state regulatory authority to govern the activities of life insurers. Congress did not intend to overturn greater than 150 years of state regulation of insurance. State insurance regulation has been and remains capable of protecting the public against abusive insurance products. But if the CFTC or the SEC are concerned that state insurance regulators might license insurers intent upon circumventing the rules, the SEC and CFTC both have means at their disposal under the Dodd-Frank Act to thwart any such efforts through direct and specific rulemaking as contemplated by proposed clarifying language set forth in this letter.

[7] Nothing in this letter about the swap definition, or our November 8, 2010, discussion with your CFTC and SEC colleagues, relates to any existing exclusions provided by the Dodd-Frank Act or to stable value contracts that will be the subject of a study mandated by the Act within 15 months of enactment.

II. Clarification of Swap Definition

The CFTC and the SEC should clarify the swap definition in order to exclude an insurance contract or transaction from the definitions of swap and security-based swap based on a three part test. First, under the mechanics of our proposal below, the contract must be issued by an insurance company and subject to state insurance regulation[8] as described in paragraph (1) of the exclusion. Second, the contract must be type of contract issued by insurance companies as described in section (2) of the exclusion. Third, the insurance contract must not be a type of contract that the CFTC or the SEC wishes to regulate.

A. Proposed Clarification of the Swap Definition Concerning Insurance Contracts[9]

"The terms 'swap' and 'security-based swap' do not include any agreement, contract or transaction that:

(1) Is issued or engaged in by an insurance company (as defined by Section (2)(a)(17) of the Investment Company Act of 1940)(15 U.S.C. 80a-2(a)(17) in respect of which the sale, reserving, payment or performance of such agreement, contract or transaction is subject to supervision by an insurance commissioner or similar official or agency of a State, or any receiver or similar official or liquidating agent for such company, in his capacity as such;
(2) Is an insurance contract, including, without limitation, a life insurance contract, annuity contract, endowment, funding agreement, guaranteed investment contract, settlement option , long-term care insurance contract, disability insurance contract, or any reinsurance contract in respect thereof, that is issued on an individual, group or other basis, whether fixed, variable or otherwise, and is supported by such insurance company's general assets or separate accounts, as permitted under state insurance law; *and*,
(3) The CFTC or the SEC has not determined by rule or regulation to be a swap or security-based swap, based on an individual determination that state regulation of the contract is insufficient to warrant the exclusion following a notice and opportunity for a hearing on the record under the Administrative Procedure Act.

[8] ACLI's September 20, 2010, submission on the "core" definitions under the advance notice of proposed rulemaking provided a discussion about the comprehensive nature of state insurance regulation over life insurers' investments at Appendix B. ACLI also provided a larger discussion about the extensive scope of state insurance regulation in an August 20, 2010 submission with the SEC on aspects of Title IX of the Dodd-Frank Act in a section entitled A Comprehensive System of Regulation Governs the Distribution of Insurance and Annuity Contracts at page 204 of http://sec.gov/comments/4-606/4606-2669.pdf . *See also* page 27 *Id.*
[9] A parallel revision to the term "security-based swap" should also be implemented along these lines.

III. Analysis of other Commentators' Observations in the Advanced Notice of Proposed Rulemaking on "Core" Definitions

One comment letter on the "core" definition proposal attempted to prescribe tests for defining the functional distinction between federally-regulated swaps and state-regulated insurance products.[10] The commentator's suggested multi-part definitions of insurance that rely on linking payments to loss contingencies and insurable interests are unworkable and fall well short of covering a wide range of common insurance products, particularly those used in the retirement markets. For example, using the following factors to validate that an insurance product is not a "swap" would be incompatible with many traditional insurance products:

- *Contingent payment does not vary with the price of any asset*. This factor is not consistent with common variable life insurance and variable annuity products, which deliver insurance guarantees that do vary with the performance of specified assets, generally specific assets allocated to insurance company separate accounts. Also, equity indexed annuities promise a payment based on the performance of an index or other basket of assets.
- *Contract owner has an "insurable interest" or reasonable expectation of loss upon the occurrence of the contingency*. Insurable interest is a term of art used in the insurance industry to avoid wagering or gambling to profit from an insurance contract. It is the insurance principle, for example, that prevents any person from taking life insurance on a stranger or insuring the property of a stranger for speculative gain. However, this insurance principle is not universally applied to other types of insurance products, such as annuity contracts, where the moral hazard of gaining from someone's loss is not present. The absence of uniform insurable interest standards that apply to all traditional insurance products makes this an unworkable measure for distinguishing between a swap and insurance.
- *Contract limits payment or performance to the actual loss arising*. This insurance concept of indemnification is standard for property/casualty contracts and reinsurance transactions, which attempt to put the insured in the same position as prior to the insured loss (i.e., "make whole"). But this factor does not apply generally to wide range of insurance products that provide for payments not directly connected to the amount of any loss incurred. For example, long-term care policies may provide for payment of a fixed amount per day, regardless of the amount of actual losses arising from the inability to perform activities of daily living. The same is true for disability income insurance policies, which may pay a periodic benefit without regard for the actual losses arising from the disability. Annuity products may provide for guaranteed lifetime payments or withdrawal benefits, which are not

[10] Letter of Cleary Gottlieb Steen & Hamilton, dated September 21, 2010. http://sec.gov/comments/s7-16-10/s71610-63.pdf . ACLI fully disagrees with the conclusions in this letter that insurance contracts fall within the definition of the term swap; the letter appears to be based solely on the intentionally broad wording, without regard to the extensive deliberative context that provides much greater basis for interpreting Congressional intent. Following the near economic collapse of 2008, the administration and Congress worked for over 18 months to develop comprehensive reform that would prevent future similar incidents. The scope of the task facing Congress was profound, and in order for Congress to complete the legislation before the summer 2010 recess and campaigns for fall 2010 mid-term elections, many aspects of the legislation were left intentionally broad and unfinished, with significant details delegated to regulatory agencies for implementation. Interpretation of the legislation, therefore, must consider the legislative environment and the broad approach taken by Congress with the explicit instruction for implementing regulations. A simple review of the language alone is insufficient.

> in the form of an indemnity for any loss event. Similarly, ordinary life insurance death benefits under a term or whole life insurance policy generally are not directly related to the specific economic losses of a beneficiary; not only does the purchaser of the life insurance simply select the death benefit amount but the beneficiary can be changed after the policy has been purchased so there may be absolutely no nexus between the payment of the death benefit and anything that could be labeled an "actual loss."

* * * *

In conclusion, we greatly appreciate your accessibility, and your attention to our views. Please let me know if you have any questions

Sincerely,

Carl B. Wilkerson

Carl B. Wilkerson

Appendix 2: GAO Report on "Definitions of Insurance"

GAO
Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, D.C. 20548

February 23, 2006

The Honorable Michael G. Oxley
Chairman
Committee on Financial Services
House of Representatives

Subject: *Definitions of Insurance and Related Information*

Dear Mr. Chairman:

This letter transmits to you our briefing slides concerning a variety of issues related to identifying a universal definition of insurance and the challenges associated with doing so. We briefed your committee staff on the preliminary results of our work on June 24, 2005, and on our final results on November 29, 2005. Specifically, we provided information on (1) the elements that are commonly part of definitions of insurance, (2) a few products not universally defined as insurance or regulated across the states by their insurance departments, (3) possible regulatory implications of developing separate definitions for insurance products covering insurance risks in more than one category, (4) current developments in statutory and financial accounting communities in re-evaluating their guidelines for measuring risk transfer in reinsurance contracts, and (5) certain circumstances when finite risk contracts are used.

We focused on insurance and reinsurance in the private sector and excluded federal insurance programs. We identified elements crucial to defining or developing a definition of insurance, but we did not attempt to compile an exhaustive list of all private sector products that might be considered insurance. We reviewed relevant documents from the National Association of Insurance Commissioners (NAIC), academic sources, accounting boards, insurance companies, professional and industry associations, state insurance regulators, federal securities regulators, court cases, and general media. We also met with knowledgeable staff at NAIC and other professional and industry associations. We conducted our work from December 2004 through December 2005 in accordance with generally accepted government auditing standards.

Definitions of Insurance

We looked at a variety of sources to identify a definition of insurance and found that, while most definitions differed because they were developed for specific purposes or had changed over time, the definitions shared key elements of risk transfer and risk spreading. Definitions of insurance are developed for various purposes such as different fields of study, categories of insurance, and state or federal statutes.[1]

While risk transfer and risk spreading are key elements, these definitions often include other elements, or parameters, commonly found in the definitions. These include

- indemnification, which is the payment for losses actually incurred;
- the ability to make reasonable estimates of future losses;
- the ability to express losses in definite monetary amounts; and
- the possibility of adverse, random events occurring outside the control of the insured.

Further, while products may transfer various types of risks, a product must transfer insurance risk to qualify as an insurance product. Insurance risk is coverage for exposures that have the potential for financial loss. It is defined by NAIC as equivalent to underwriting risk. That is, for property-casualty insurers, it is the risk of mispricing new business or the risk of underestimating needed reserves for business already written. The accounting industry defines insurance risk as those risks related to uncertainties resulting from both the amount and timing of losses paid and other expenses.

Even when some losses lack certain elements of insurance, insurers have sometimes found ways that allow coverage for such losses. For example, nonpecuniary or noneconomic losses (e.g., the loss of well-being or happiness) lack certain elements of insurance—there is no commonly

[1]For example, the Gramm-Leach-Bliley Act, section 302(c) defines insurance by, among other things, making reference to state insurance laws (see slide 8).

accepted method of expressing a definite monetary amount for nonpecuniary losses and no measurable means to indemnify the insured. For example, the loss of happiness upon the death of a loved one would be difficult if not impossible to quantify in monetary terms; instead of attempting to quantify such a loss, life insurers agree to pay a predetermined amount of monetary benefits upon the death of the insured, and they charge a premium based on both the amount of insurance and the expected mortality risk of the insured.

In reviewing the various definitions of insurance, we also found that court interpretations and state regulatory practices change definitions over time. For example, courts have emphasized different elements of an insurance contract such as its principal object and purpose as in *Jordan v. Group Health* or have focused on the legal elements necessary for an enforceable contract as in *Griffin Systems v. Washburn*.[2] (See slides 5-8 and 13-15 for further discussion of various definitions of insurance.)

How States Define and Regulate Insurance

Generally, states define and regulate the same products as insurance. While states rely on a variety of sources to provide a legal and regulatory definition of insurance, these sources sometimes lead to differences in how certain products are categorized—whether as insurance or not. In an effort to reduce confusion, NAIC has attempted to catalog products regulated by each of the state insurance regulators in standardized lists known as Uniform Product Coding Matrices (UPCM)—one for property casualty products and another for life/accident/health products. Insurers are to use the UPCM as a guide for filings of insurance rates and policy forms. Most of the products in the UPCM are recognized and regulated across all states as insurance. However, some differences still exist. For example, prepaid legal service plans are defined and regulated as insurance in Texas but not in South Carolina.

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[2]The *Jordan* case focused on insurance contracts that also contained noninsurance features and looked at both the insurance and noninsurance features to determine the "principal object and purpose" of the contract *Jordan v. Group Health Ass'n.*, 107 F.2d 239, 247-48 (D.C. Cir. 1939). The *Griffin* case articulated four elements of an insurance contract: (1) a contract between an insurer and insured that exists for a specific period of time, (2) an insurable interest possessed by the insured, (3) consideration in the form of a premium paid by the insured to the insurer, and (4) the assumption of risk by the insurer who agrees to indemnify the insured for potential loss resulting from specified perils *Griffin Systems v. Washburn*, 505 N.E.2d 1121, 1123-24 (Ill. App. Dist. 1987).

Many states have a statutory definition that is stated generally and may explicitly include and/or exclude specific insurance products.[3] A few states do not have a general definition. For example, Illinois' statute lists classes of products subject to or excluded from regulation. When a product is not listed in the statute, Illinois regulators apply a functional definition consisting of the elements articulated in *Griffin Systems v. Washburn*.

We identified some products either not included in the UPCM or subject to differences in statutory or regulatory approaches among various state insurance regulators. These include

- products created and offered by noninsurers as substitutes for other products underwritten by insurers (e.g., debt cancellation contracts created by lenders as substitutes for credit insurance; see slide 18);

- products that are viewed sometimes as insurance and other times as prepayment or discount payment plans for services (e.g., legal and medical services plans; see slides 21-22);

- various annuity products sold by insurers because whether a particular annuity product is insurance hinged on the level of insurance risk and/or investment risk assumed by the insurer (e.g., variable annuities in which the insurer assumes no investment risk and period certain annuities in which the insurer assumes no mortality risk; see slides 27-28); and

- insurance products regulated by state departments other than state insurance departments because of their historical association with particular industries or economic activities (e.g., title insurance that, according to a state insurance department official, is historically associated with the real estate market; see slide 31).

Products we identified with differences in regulatory approaches among some state insurance regulators are listed and discussed on slides 18-31.

[3]An example of a statutory definition that is stated generally is: "Insurance is a contract whereby one undertakes to indemnify another or pay a specified amount upon determinable contingencies."

Regulation of Products That Cover Insurance Risks in More Than One Category

Products that cover insurance risks in more than one category (life, accident, health, property casualty) could face uncertain regulation if separate insurance definitions were developed and used for each category. Currently, insurance products are classified by regulators as life, accident,[4] health, or property casualty insurance, even though some products cover insurance risks in more than one of these categories.

Based on the product descriptions in NAIC's UPCM, we list and describe eight insurance products we found that cover risks in more than one of the categories (slides 33-34). Our list was not intended to be exhaustive but to illustrate that some products could actually fit in two or more categories even though each product is historically associated with one particular category of insurance. The historical associations have not affected insurance regulation because insurance definitions generally apply across categories. However, if separate statutory definitions of insurance were developed for each category, it is unclear how products characterized by features from multiple categories would be classified for regulatory purposes. As a result, products that cover insurance risks in more than one category might be regulated differently or might be regulated under multiple regimes. For example, it is unclear whether accident insurance that also provides death and health care benefits would be regulated solely as accident insurance or also as both life and health insurance, and whether regulation would differ across the three types of insurance. (See slides 32-34 for additional information on this issue.)

Reinsurance

Reinsurance is insurance for insurers. In contrast to insurance, reinsurance is not sold as a standard product. Each contract is separately negotiated. Two basic types of reinsurance contracts exist—treaty and facultative. The key difference between treaty and facultative reinsurance contracts is how insurers select risks for transfer. In a treaty reinsurance contract, the reinsurer and insurer agree on which select class(es) of underlying policies of the insurer's to underwrite. In a facultative reinsurance contract, the reinsurer and insurer agree on individual underlying policies. In addition to

[4] Accident insurance is a form of health insurance against loss by accidental bodily injury. ("Fundamentals of Risk and Insurance," by Emmett J. Vaughan and Therese Vaughan).

the method of selecting underlying policies, reinsurance contracts usually contain features such as floors and caps that limit the amount of risks underwritten.

The transfer of risk is the key element to defining reinsurance. While reinsurance contracts can also transfer noninsurance risks, it is the transfer of insurance risk that is the focus when evaluating the validity of a reinsurance contract. Further, if sufficient insurance risk is transferred, the entire contract can be defined as reinsurance and qualify for reinsurance accounting—a type of accounting treatment sought when beneficial to the insured's financial statements.[5] Currently, the statutory and financial accounting communities are re-evaluating methods used in determining whether a reinsurer's contract covering property casualty insurance risks actually transfers insurance risk. Both statutory and financial accounting standards establish the necessary conditions of risk transfer for reinsurance contracts including that the reinsurer assume significant insurance risk and face a reasonable possibility of significant loss.[6] Statutory and financial accounting guidelines also clarify that while reinsurance contracts may transfer other types of risks, such as investment risk, only insurance risk is subject to the conditions for determining risk transfer. Also, the guidelines require that determinations of risk transfer should consider all features in a contract such as cancellation provisions or payment schedules that delay the reinsurer's timely reimbursement of claims; features like these may limit the transfer of insurance risk. In addition, financial accounting guidelines explain that determining the extent of risk transferred in one reinsurance contract should be done in the context of all other related contracts or agreements because they may potentially limit the transfer of insurance risk. However, once the determination is made that the contract transfers sufficient insurance risk,

[5]For clarity, contracts that do not transfer sufficient insurance risk can be referred to as "reinsurer's contracts."

[6]The NAIC issues Statements of Statutory Accounting Principles (SSAP) that provide guidance for required filings of insurance company financial statements to state insurance regulators and the NAIC. Another accounting organization, the Financial Accounting Standards Board, also establishes financial accounting and reporting standards—Statement of Financial Accounting Standards—some of which are specifically for insurance and reinsurance companies and transactions. NAIC's Statement of Statutory Accounting Principles No. 62 and FASB's Statement of Financial Accounting Standards No. 113, paragraphs 9a and 9b, establish the necessary conditions of risk transfer for contracts: (1) "reinsurer assumes significant insurance risk under the reinsured portions of the contract" (commonly called the "9a test") and (2) "It is reasonably possible that the reinsurer may realize significant loss" (commonly called the "9b test").

reinsurance accounting can be applied to the entire contract, including any noninsurance risks being transferred. (See slides 35-42 for further information on reinsurance.)

Finite Risk Contracts

No widely accepted definition exists for finite risk contracts. Finite risk contracts can be used by both insurers (finite risk reinsurance) and noninsurers (finite risk insurance). In general, such contracts transfer less insurance risk than traditional reinsurance or insurance. Instead, finite risk contracts tend to emphasize financing and accounting benefits. Specifically, the contracts allow the insured to transfer to a reinsurer or insurer both insurance risk and uncertainties about the timing of certain cash flows and recognition of certain income and expenses. Thus, an insured could use these contracts to both reduce insurance risk and control or smooth the timing of cash flows and the recognition of certain expenses and income. This could favorably affect earnings, capital, and certain ratios that regulators, rating agencies, and investment analysts might use to measure and monitor a company's financial health.

Finite risk contracts must transfer sufficient insurance risk to legitimately qualify for these financing and accounting benefits. Although finite risk contracts can be legitimately structured to meet these requirements, some companies that originally presented their finite risk contracts as transferring sufficient insurance risk, and thus qualifying for the financing and accounting benefits, were discovered to have used mechanisms such as undisclosed side agreements that resulted in little or no insurance risk actually being transferred. Disguising such contracts to look like "real reinsurance" or insurance can mislead regulators, policyholders, and investors about the actual financial condition of the company. (See slides 43-47 for further discussion of finite risk contracts.)

In summary, we found that there is no single, universal definition of insurance. However, we identified certain key elements of risk transfer or risk spreading that were common among the varying definitions. Moreover, while statutory definitions of insurance sometimes differed between states leading to differences in the regulation of certain products, states generally define and regulate the same products as insurance. Insurance products also are categorized by type of insurance risk such as life, accident, health, and property casualty. However, some products, while designated as belonging to one of the major categories, have characteristics that fall into more than one category. Therefore, if separate statutory definitions of insurance were developed for products in each category of insurance risk, products that transfer insurance risks in more than one category could face uncertain regulation.

Concerning reinsurance and its accounting treatment, the amount of insurance risk actually transferred is important because of the benefits of reinsurance accounting to the ceding company. Specifically, if insurance risk is transferred at sufficient levels, the entire contract would qualify for reinsurance accounting, with resulting positive effects on the ceding company's reserves and surplus. Another type of contract—the finite risk contract—can receive reinsurance accounting or other preferred accounting treatment but transfers less risk at a lower premium than traditional insurance. Recently some companies that had these contracts and used reinsurance accounting treatment were found to have transferred insufficient insurance risk to qualify for such treatment.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the date of this report. At that time, we will send copies of this report to the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs and the Ranking Minority Member of the House Committee on Financial Services. We also will make copies available to others upon request. In addition, the report will be available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staff have questions regarding this report, please contact me at (202) 512-5837 or williamso@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Lawrence D. Cluff, Angela Pun, Mel Thomas, Christine J. Kuduk, Nancy S. Barry, and Tania L. Calhoun made key contributions to this report.

Sincerely yours,

Orice M. Williams
Director, Financial Markets and Community Investment

Enclosure

GAO
Accountability * Integrity * Reliability

Definitions of Insurance

Presentation For
Committee on Financial Services
U.S. House of Representatives

Contents

Scope and Methodology

- We focused on products sold by insurers or reinsurers in the private sector and excluded federal insurance programs.
- We did not attempt to compile an exhaustive list of all products in the private sector that might be considered insurance.
- We reviewed academic textbooks and journals; documents from National Association of Insurance Commissioners (NAIC), state insurance regulators, Securities and Exchange Commission, and National Association of Securities Dealers; statutory and financial accounting principles and standards; general media; and court cases.
- We interviewed officials from NAIC, industry associations for life, health, and property casualty insurance, as well as banking and other professional associations. We also interviewed academicians and officials with the Illinois insurance department.

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Definitions of Insurance

In our research, we found that

- There is no universal agreement on a definition of insurance,
- Most definitions have common elements,
- The Gramm-Leach-Bliley Act provides one definition used by the federal government,
- Nonpecuniary losses are usually not covered by insurance, and
- Identity theft insurance pays only for actual expenses incurred by the victim.

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Definitions of Insurance

No Universal Agreement

Insurance industry participants and state regulators develop definitions for different purposes, such as

- Specific subject areas, such as accounting, actuarial science, economics, and finance;
- Specific types of insurance, such as life or property casualty; or
- Statutes and regulations, which can vary across states.

These definitions are dynamic, sometimes caused by

- Evolution of thinking in subject areas;
- Product innovations; and
- Changes in statutes, regulations, and court interpretations.

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Definitions of Insurance

Key Elements

Definitions of insurance have two key elements:

- Risk is transferred.
  - An uncertain, possibly large, loss is transformed into a certain, small cost or premium for the insured; and
  - An insured transfers risk to another entity.

- Risk is spread. That is, an insurer spreads risk over a large enough group for the law of large numbers to predict both total losses and the probability of a single loss with some accuracy.

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Definitions of Insurance

Other Elements

Other elements often considered to be conditions necessary for an “insurable” risk are

- Risks that are reasonably homogeneous and independent; and
- Losses that meet certain conditions, including
  - Chance occurrences,
  - Low probability of loss,
  - Occur at a definite time and place, and can be expressed as a definite monetary amount, and
  - Are not catastrophic, i.e., do not affect a large number of insureds at the same time.

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Definitions of Insurance

Gramm-Leach-Bliley Definition

Section 302(c) defines insurance as

- Any product regulated as insurance as of Jan. 1, 1999, in accordance with the relevant state insurance law, in the state in which the product is provided; and
- Any product first offered after Jan. 1, 1999, which
  - A state insurance regulator determines shall be regulated as insurance in the state in which the product is provided because the product insures, guarantees, or indemnifies against liability, loss of life, loss of health, or loss through damage to or destruction of property, including, but not limited to, surety bonds, life insurance, health insurance, title insurance, and property and casualty insurance; and
  - Is not a product or service of a bank as described in the section; and
- Any annuity contract, the income on which is subject to tax treatment under section 72 of the Internal Revenue Code.

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Definitions of Insurance

Description of Nonpecuniary Losses

Pecuniary or economic losses have a market price or can be calculated in monetary terms. Some examples include

- The cost to repair or replace a damaged vehicle, or
- A family's loss of future expected income from the death or disability of an income-earning parent or spouse.

Nonpecuniary or noneconomic losses do not have a market price. These losses are the reduction of insureds' welfare such as their health, well-being, and happiness.

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Definitions of Insurance

Nonpecuniary Losses Lack Certain Common Elements, but Some Coverage Provided

Nonpecuniary losses lack certain common insurance elements. For example

- Nonpecuniary losses cannot be calculated as a definite amount;
- The principle of indemnity does not apply; and
- There is no insurable interest for some types of nonpecuniary losses.

Insurers provide coverage for some nonpecuniary losses by paying

- Predetermined monetary amounts, such as life insurance paying the amount chosen by the insured at time of purchase; or
- Amounts calculated in monetary terms under specific circumstances, such as uninsured motorist insurance covering damages for "pain and suffering."

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Definitions of Insurance

Identity Theft Insurance Covers Pecuniary Expenses

Although the theft of one's identifying information is a nonpecuniary loss, identity theft insurance only pays for associated expenses that have a market price or can be calculated in monetary terms. These include

- Costs of certified mail and long-distance calls;
- Lost wages from time taken off work; and
- Fees, such as attorney and loan application fees.

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How States Define and Regulate Insurance

States rely on a variety of sources to help define and regulate insurance. These include

- State statutory definitions,
- Court interpretations,
- Regulatory descriptions of insurance products, and
- Uniform Product Coding Matrices (UPCM) categories of insurance.

However, some products are not universally recognized or regulated as insurance.

How States Define and Regulate Insurance

State Statutory Definitions

- Many states have a statutory definition that is general and inclusive, similar to the following:

  Insurance is a contract whereby one undertakes to indemnify another or pay a specified amount upon determinable contingencies (Kentucky Revised Statutes § 304.1-030)

- Some states have explicit inclusions and/or exclusions. For example, Kentucky's definition includes annuities and sureties, while Wisconsin's excludes continuing care contracts.

- A few states do not have a statutory definition. For example, Illinois' insurance statutes list classes of products subject to or excluded from regulation. When a product is not listed in the statutes, the regulators apply a functional definition consisting of the elements articulated in a court case.

How States Define and Regulate Insurance

Court Interpretations

Two court cases have helped guide states in defining and regulating insurance:

- *Jordan v. Group Health* found that courts may look at the nature of the contractual relationship to determine whether risk transfer or distribution is its "principal object and purpose."
- *Griffin Systems v. Washburn* found that courts may look to see whether a product contains certain elements within a definition of insurance. These elements include
  - A contract between an insurer and insured that exists for a specific period of time,
  - An insurable interest possessed by the insured,
  - Consideration in the form of a premium paid by the insured to the insurer, and
  - The assumption of risk by the insurer who agrees to indemnify the insured for potential loss resulting from specified perils.

How States Define and Regulate Insurance

Regulatory Descriptions of Insurance Products

NAIC worked with insurance departments in 20 to 25 states to develop the UPCM that lists and describes

- Property/Casualty insurance products, and
- Life/Accident/Health insurance products.

NAIC developed the UPCM to

- Identify all products regulated by state departments of insurance,
- Standardize terminology for insurance products across all states, and
- Aid filings of insurance products (rates and policy forms).

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How States Define and Regulate Insurance

UPCM Categories of Insurance

Category of insurance		Description
Property/Casualty		Coverage against loss or damage to property and liabilities to third parties resulting from such losses or damages or other events
Life, Accident, Health, Annuity, and Credit	Continuing Care Retirement Community (CCRC)	A senior housing arrangement that, in addition to housing, includes some provision for skilled nursing care
	Credit Insurance	Coverage that pays off or takes over scheduled payments on an obligation to a creditor upon occurrence of a specified event such as death, disablement, or unemployment of the insured debtor
	Health Insurance	Coverage that provides benefits for expenses related to and losses resulting from sickness, a medical condition, or an accident
	Health Maintenance Organization (HMO)	A health insurance plan with a range of medical coverages offered on a prepaid and group basis to its enrollees through medical providers under contract
	Life Insurance	Insurance contracts that provide specified benefits amounts to named beneficiaries upon the death of the insured
	Long-Term Care Insurance	Insurance that covers or reimburses for the costs of long-term care, nursing home care, and home care services
	Medicare Supplement	Coverage is known as Medigap insurance because it supplements or fills gaps in coverage of the federal Medicare Program
	Multiline	Insurance not captured elsewhere
	Viatical Settlements	Contract or agreement in which a third party purchases all or a part of a policyholder's life insurance policy

Source: Based on information from NAIC.

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How States Define and Regulate Insurance

Products Not Universally Recognized or Regulated as Insurance

Key Issues	Product
Products created by noninsurance entities that substitute for regulated insurance products	Debt cancellation contracts & debt suspension agreements [b] Gap waivers [b] Rental car damage waivers & theft waivers [b]
Products that could be either insurance or payment plans	Legal services plans [b] Medical services plans [b] Extended service contracts [a] Preneed funeral & burial arrangements [a] Continuing care retirement communities [a] Preventive health care coverage [a]
Products underwritten by insurers that contain investment risk	Variable annuities and equity indexed annuities [a] Period certain annuities [b] Viatical settlements & life settlements [a]
Insurance and insurance-like products not always regulated by state departments of insurance	Surety contracts [a] Title insurance [a]

Notes: [a] Located in NAIC's Uniform Product Coding Matrices.
[b] Not located in NAIC's Uniform Product Coding Matrices.

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How States Define and Regulate Insurance

Substitutes for Regulated Insurance Products

Debt Cancellation or Suspension Contracts

Description

- Created by lenders as substitutes for credit insurance
- For a fee, lender retains risk in lieu of pursuing collection and potential recovery on loan if borrower defaults
- Lender agrees to cancel or temporarily suspend loan under conditions such as death, disability, or unemployment of borrower
- Unclear whether these are a transfer of insurance risk or forgiveness of financial obligation
- Equivalent to credit insurance from consumer's viewpoint

Information on regulation

- Illinois—does not view as insurance; no indemnity payments from third parties
- Michigan—does not view as insurance but as incidental to loans
- New York—views as insurance but does not regulate when sold by financial institutions

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Substitutes for Regulated Insurance Products

Gap Waivers

Description

- Created by auto dealers and others as a substitute for gap (originally, guaranteed auto protection) insurance
- For a fee, creditor retains risk by agreeing to waive the excess of the lessee's or debtor's obligation to pay the amount owed on a property over its actual cash value in the event of total loss due to theft or physical damage
- Unclear whether these are a transfer of insurance risk or forgiveness of financial obligation
- Properties include autos, boats, and computers
- Some offer gap waivers as alternative to gap insurance that other entities offer

Information on regulation

- New York—views as insurance under certain conditions; auto dealers or lenders who are not licensed as insurance agents or brokers may offer gap waivers; providers of gap waivers that in turn buy gap insurance from licensed insurers must not charge customers more than they pay
- Mississippi—has not determined whether gap waivers are insurance and does not regulate them

How States Define and Regulate Insurance

Substitutes for Regulated Insurance Products
Rental Car Damage and Theft Waivers

Description

- Created by car rental companies as a substitute for rental insurance
- For a fee, rental company retains risk by agreeing not to hold driver liable in the event of certain damages involving a rental vehicle
- Unclear whether these are a transfer of insurance risk or forgiveness of financial obligation
- Equivalent to rental car insurance from consumer's viewpoint

Information on regulation

- New York—rental company must obtain driver's written consent to buy the waiver before the driver signs the rental agreement
- Texas—does not view as insurance; are waivers of rental company's right to recover on damages to auto

How States Define and Regulate Insurance

Products That Could Be Insurance or Payment Plans
Legal Services Plans

Description

- The term is used to characterize plans that
  - provide legal services
  - pay for the cost of obtaining legal services
  - prepay for future legal services, at discounted prices
  - reimburse for legal services costs
  - prepay for future legal services, if needed
- Unclear whether these are transfers of insurance risk, price discounting plans, prepaid expense plans, or some combination

Information on regulation

- New York—included in the list of authorized insurance is legal services insurance that is defined as providing legal services or reimbursement for the cost of legal services
- South Carolina—prepaid legal service contracts regulated by the state's Department of Consumer Affairs
- Texas—prepaid legal insurance is insurance if one party prepays another for future legal services that may or may not be needed and if the other party assumes the risk that such services may be needed

How States Define and Regulate Insurance

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Products That Could Be Insurance or Payment Plans

Medical Services Plans

Description

- Some physicians and medical groups offer prepayment plans to patients
  - to avoid the administrative burden of third-party health insurance
  - that appear to operate as insurer/providers (such as HMOs) on a smaller scale
- Unclear whether these are transfers of insurance risk, price discounting plans, prepaid expense plans, or some combination

Information on regulation

- New York—A plan in which patients prepay for future medical care needs
  - would be insurance and require licensing if the plan provides unlimited services dependent on the happening of a fortuitous event that could cost more than the prepayment
  - would not be insurance and not require licensing if certain services occasioned by the happening of a fortuitous event are offered for an additional fee that covers the cost of the services, although discounted from the usual fee

How States Define and Regulate Insurance

Products That Could Be Insurance or Payment Plans

Extended Service Contracts (ESC)

Description—typically sold for autos, “home” (major home appliances), and consumer products

- Providers assume future costs of repairs or maintenance for a fee
- Not to be confused with written or implied warranties of fitness and merchantability provided by the manufacturer
- Some state courts have determined that ESCs are insurance when the seller of an ESC is not the manufacturer but a repair service provider

Information on regulation—Regulation in some states is based on state court decisions such as those discussed in the *Griffin v. Washburn* case:

- Arizona court—ESC is insurance because third-party insurer sold ESC
- Texas and Virginia courts—ESC is not insurance because merchant of product sold ESC and makes repairs

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How States Define and Regulate Insurance

Products That Could Be Insurance or Payment Plans

Preneed Funeral and Burial Arrangements

Description

- Purchase of future funeral services and merchandise at locked in current price
- Can be unfunded or funded in advance of need
- Advance payments are deposited in interest-bearing trust account or used to buy funeral insurance
- Can also be funded with future life insurance or annuity proceeds upon death
- Are typically revocable and movable at any time by consumer and trust account prefunding is returnable
- Unclear whether these are a transfer of insurance risk, price discounting plans, or prepayment of expenses

Information on regulation

- Arkansas—licenses and regulates sales of such services; state finance division examines contracts and bank trust accounts
- California—Department of Consumer Affairs' Cemetery and Funeral Bureau licenses and regulates funeral establishments that sell such services
- Colorado—regulates sellers

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How States Define and Regulate Insurance

Products That Could Be Insurance or Payment Plans

Continuing Care Retirement Communities (CCRC)

Description

- Senior housing arrangements that provide for skilled nursing care, if later needed
- Three types of communities
  - Type A—fee is locked in if skilled care is later needed
  - Type B—fee for skilled care is locked in for limited time with later increases that don't reach market rate
  - Type C—access to later skilled care is assured, but at full market rate
- Unclear whether these are transfers of insurance risk, price discounting plans, or prepayments of expenses

Information on regulation

- California—Department of Social Services certifies and regulates CCRCs, but state insurance code regulates uncertified CCRCs
- North Carolina—CCRCs must be licensed by the commissioner of insurance and state insurance code governs their activities
- South Carolina—CCRCs do not include nursing home or residential care facilities licensed by state Department of Health & Environmental Control
- Unclear how many state insurance departments regulate CCRCs

How States Define and Regulate Insurance

Products That Could Be Insurance or Payment Plans

Preventive Health Care Coverage

Description

- Covers health care to keep healthy or to prevent illness
- Health insurance plans appear to typically cover preventive care
- Includes annual physicals, pelvic exams, flu shots, screening mammograms, and dental cleanings
- Many preventive health care activities tend to be recurring and predictable
- Unclear whether these are a transfer of insurance risk, price discounting, or prepayment of expenses

Information on regulation

- Required by some states to be included in health insurance
- Traditionally included in health insurance

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How States Define and Regulate Insurance

Products Underwritten by Insurers Containing Investment Risks

Variable Annuities and Equity-Indexed Annuities

Description

- Annuity—a contract that, in return for premium(s) paid, guarantees a series of payments for a specified period or for life.
- Variable annuity—pays a rate of return based on the performance of investments. Interest rate and principal are usually not guaranteed. The customer retains almost all of the investment risks.
- Equity-indexed annuity—pays a minimum rate of return plus an extra rate using a formula based on charges to an equity index such as the S&P 500. The contract usually guarantees a minimum account value. The customer retains some of the investment risk.
- Insurer assumes mortality risks through added features, if offered, such as payments for life and death benefits.

Information on regulation

- Variable annuities
  - Sold by insurance companies, but regulated by SEC
  - In some states, state securities regulators have authority over variable annuities
  - State departments of insurance (DOI) regulate the insurer selling the product
- Equity-indexed annuities are sold by insurance companies and the SEC is evaluating them to determine if they should be regulated as securities

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How States Define and Regulate Insurance

Products Underwritten by Insurers Containing Investment Risks

Period Certain Annuities

Description

- Pay a fixed rate of return over a specified term such as 5, 10, 15, or 20 years
- Customer shifts all investment risks to the insurer
- As with any annuity, the insurer could assume mortality risks through added features such as death benefits or retirement benefits, if offered

Information on regulation

- Traditionally regulated by DOI as an insurance product
- Illinois—If an annuity transfers mortality risks to the insurer, it is regulated.

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GAO Accountability * Integrity * Reliability

How States Define and Regulate Insurance

Products Underwritten by Insurers Containing Investment Risks

Viatical Settlements and Life Settlements

Description

- Viaticals—policyholders are usually ill with under 2 years of life expectancy
- Life settlements—policyholders are over 65 with normal life expectancy
- Each product may be bundled together and sold to investors
- In both cases
  - Third party pays policyholder cash and becomes a beneficiary of the life insurance death benefit
  - The cash payment is more than the cash surrender value of the policy but less than the expected death benefit
- Unclear whether these products pose insurance risk or investment risk

Information on regulation

- Sometimes regulated by DOI, sometimes by state securities regulator, and sometimes by both
- Some states adopted NAIC's Viatical Settlements Model Act, which requires viatical companies to be licensed by a state DOI
- In California, Connecticut, New York, and Washington, settlement providers are licensed by the DOIs

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How States Define and Regulate Insurance

Insurance and Insurance-Like Products That Are Not Always Regulated by State DOIs

Surety Contracts

Description

- A contract where the surety (similar to insurance company) agrees, for a fee, to perform the principal's (similar to the policyholder) obligations to a third party in the event the principal fails to perform
- Surety assumes risk from the third party that the principal will not perform contractual obligations
- Unlike insurer, surety has a right to seek indemnification from the principal after performing contractual obligations

Information on regulation

- New York and Utah—If an issuer sells surety bonds as a vocation, as opposed to incidental to other business activity, then it is subject to insurance regulation
- Kentucky and Delaware—Their statutory definitions explicitly include those who "act as surety"

How States Define and Regulate Insurance

Insurance and Insurance-Like Products That Are Not Always Regulated by State DOIs

Title Insurance

Description

- For a fee, an insurer agrees to indemnify the insured up to a specified amount of loss for defects in the title to real property
- Typically required by mortgage lenders at property settlement

Information on regulation

- Iowa—This is the only state that does not allow the sale of title insurance within its borders; the state's Finance Authority operates a Title Guaranty Program.
- Illinois—Regulated by the Division of Financial Institutions, not the state DOI
- Regulatory treatment does not vary widely among the states

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Regulation of Products That Cover Insurance Risks in More Than One Category

Some products, while defined by NAIC as belonging to a particular category of insurance, have characteristics that also fit in other categories.

We have

- Described the products, and
- Identified the categories of risks covered by each product.

Regulation of Products That Cover Insurance Risks in More Than One Category

Product Descriptions

Product	Description
Accident	Coverage for death, dismemberment, disability, or hospital and medical care caused by or necessitated as a result of specified accidents
Credit Disability	Makes monthly loan/credit transaction payments to the creditor upon the disablement of an insured debtor
Credit Life	Coverage sold in connection with loan and credit transactions to provide insurance protection against death
Credit Insurance	Coverage of an obligation to a creditor upon the death or disablement of the insured debtor; includes coverage that protects the value of collateral for a loan
Disability Income	Coverage designed to compensate insured individual for a portion of the income they lose because of a disabling injury or illness
Employee Benefit Liability	Liability protection for employers against employee claims such as for wrongful termination or improper calculation of employee benefits from pension plans, group life, health, or disability income insurance or accidental death and dismemberment insurance
Employers Liability	Coverage for the legal liability of employers arising out of injury to employees
Workers' Compensation	Coverage for an employer's liability for injuries, disability, or death to persons in their employment, without regard to fault, as prescribed by state or federal workers' compensation laws or other statutes

Source: GAO analysis of lines of insurance descriptions.

Regulation of Products That Cover Insurance Risks in More Than One Category

Categories of Risks Covered by One Product

Product	Insurance Category			
	Property/Casualty	L/A/H		
		Life	Accident	Health
Accident		O	P	O
Credit Disability	P		O	O
Credit Life	P	O		
Credit Insurance	P	O	P	
Disability Income	O		P	
Employee Benefit Liability	P	O	O	O
Employers Liability	P		O	
Workers' Compensation	P	O	O	

P = Product's insurance category in NAIC's Uniform Product Coding Matrix.
O = Other categories with products that have similar features.
* Credit insurance is listed under two categories in NAIC's UPCM.

Source: GAO analysis of lines of insurance descriptions.

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Reinsurance

Some of the principal elements of reinsurance and its uses include

- The definition of reinsurance,
- Reinsurance contracts,
- Reinsurance and risk transfer,
- The 9a and 9b “tests” for risk transfer,
- The benefits of statutory reinsurance accounting for insurers, and
- Reinsurance contracts permit the transfer of varying levels of risk.

Definitions of Insurance 35

Reinsurance

Definition

The Reinsurance Association of America defines reinsurance as

> A transaction whereby the assuming reinsurer, for a payment, agrees to indemnify the ceding insurer against all, or a part, of the loss which the latter may sustain under the policy or policies which it has issued.

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Reinsurance

Reinsurance Contracts

- Reinsurance is not sold as a standardized product. Each contract is separately negotiated.
- Regulators look for risk transfer in each contract to determine if reinsurance has occurred.
- Two basic methods of assuming risks in reinsurers' contracts are
  - Treaty reinsurance, which usually covers a part or a percentage of a book of an insurer's business, for example, all of an insurer's medical malpractice policies with hospitals; and
  - Facultative reinsurance, which covers individual policies, usually of a unique nature, for example, an insurer's medical malpractice policy with the Mayo Clinic.

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Reinsurance

Reinsurance and Risk Transfer

Statement of Statutory Accounting Principles

Reinsurance is the assumption by an insurer of all or part of an insurance risk undertaken originally by another reinsurer.

(Accounting Practices and Procedures Manual, NAIC, underlining added)

Statement of Financial Accounting Standards

Insurance provides indemnification against loss or liability from specified events during a specified period. The insurer (or ceding enterprise) pays (cedes) an amount to the reinsurer, and the reinsurer agrees to reimburse the insurer for a specified portion of claims paid under the reinsured contracts indemnification against loss or liability under a reinsurance contract generally referred to as risk transfer. *(Financial Accounting Standard No. 113, underlining added)*

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Reinsurance

Reinsurance and Risk Transfer

- Risk transfer requires that the reinsurer indemnifies the insurer for unexpected losses.
- Insurance risk does not include investment risk.
- Insurance regulators bear responsibility for determining whether risk transfer has occurred for statutory purposes.
- Risk transfer is determined by applying financial and statutory accounting guidelines:
  - Reinsurer assumes significant insurance risk under the reinsured portions of the contract ("9a test"), and
  - It is reasonably possible that the reinsurer may realize significant loss ("9b test").

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Reinsurance

The 9a and 9b Tests for Risk Transfer

9a test

- The amount and timing of reinsurer's claims settlements should vary directly with the severity and timing of the loss event.
- The extent of risk transfer is determined by examining contract features.

9b test

- The 10/10 rule means the reinsurer has a 10 percent or greater chance of incurring a 10 percent or greater loss of the premium under the contract. While regulators do not universally agree with the "10/10 rule," it is commonly used by industry.
- The extent of risk transfer is determined through risk transfer analysis, but it can yield different results.

If a reinsurer's contract passes the 9a and 9b tests to the regulator's satisfaction, reinsurance accounting can be applied to the entire contract.

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Reinsurance

Benefits of Statutory Reinsurance Accounting for Insurers

Insurers attempt to structure reinsurance contracts to transfer sufficient risk to qualify for reinsurance accounting in order to

- Improve net income on the income statement,
- Improve the surplus on the balance sheet,
- Improve the regulatory ratios used for solvency regulation, and
- Increase the insurers ability to write more policies with existing capital.

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Reinsurance

Reinsurance Contracts Permit the Transfer of Varying Levels of Risk

Simple quota share reinsurance is a basic form of treaty reinsurance contract that fully transfers risk. In this contract, insurer and reinsurer share all business in a fixed proportion. For example, in a 70 percent quota share, 70 percent of premiums, losses, and loss expenses would be ceded to the reinsurer, while 30 percent would be retained by the insurer.

Elements added to a simple contract may limit risk transfer:

- By adding certain types of features into the contract (for example, a sliding scale ceding commission), or
- Through verbal and written side agreements that limit risk transfer.

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Finite Risk Contracts

Finite risk contracts are a mechanism for limiting risk transfer. We discuss

- Their definition,
- Their purposes,
- Current domestic and international scrutiny, and
- Organizations reviewing finite risk issues.

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Finite Risk Contracts

Definition

Finite risk contracts

- Have no global definition;
- Are called by many other names, such as financial reinsurance, financial engineering reinsurance, or structured reinsurance;
- Can take place between a reinsurer and an insurer, or an insurer and a noninsurance entity;
- May transfer to a reinsurer less insurance risk than traditional insurance—or no insurance risk—while emphasizing other features; and
- May cost less than traditional insurance or reinsurance.

Finite Risk Contracts

Purposes

Insurers may structure finite risk contracts to appear like traditional reinsurance:

- To qualify for preferential accounting and tax treatment while transferring minimal insurance risk;
- To maintain certain financial ratios, such as premiums to surplus, within acceptable or favorable limits for regulators, rating agencies, and investors; or
- For financing purposes, such as spreading multiyear timing risks, that have priority over transferring insurance risk (for example, long-tail risks).

Similarly, noninsurers might use finite risk contracts for smoothing earnings by deferring recognition of losses on major events that might otherwise be fully charged against current earnings, or for evenly spreading cash outflows associated with such events.

Such contracts, if not legitimately structured, may result in misleading financial statements.

Finite Risk Contracts

Domestic and International Scrutiny

International and U.S. organizations are reviewing issues related to finite risk contracts such as

- Disclosure requirements for finite risk contracts,
- Certification by company officials,
- Different accounting treatments for insurance risks and noninsurance risks when a reinsurance contract contains more than insurance risks ("unbundling"), and
- What constitutes the transfer of insurance risk.

NAIC has approved new requirements for property-casualty insurers that include

- Insurers reporting contract terms and management objectives for certain finite reinsurance contracts, and
- CEO and CFO attesting that no side agreements exist and that risk has transferred.

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Finite Risk Contracts

Organizations Reviewing Finite Risk Issues

U. S. organizations currently reviewing finite risk issues include
- NAIC,
- The American Academy of Actuaries,
- The Casualty Actuarial Society,
- The Financial Accounting Standards Board, and
- The Internal Revenue Service.

International organizations currently reviewing finite risk issues include
- The International Accounting Standards Board, and
- The International Association of Insurance Supervisors.

Summary

- Insurance has no single, universal definition, but definitions have key elements of risk transfer and risk spreading.
- Although definitions of insurance differ among some states and certain products are not universally recognized and regulated as insurance across all states, states generally define and regulate the same products as insurance.
- Products that cover insurance risks in more than one category (life, accident, health, property-casualty) could face uncertain regulation if separate insurance definitions are developed for each category.
- While reinsurance contracts can transfer various levels of insurance and noninsurance risks, contracts that transfer sufficient insurance risk are defined entirely as reinsurance and qualify for reinsurance accounting.
- Some finite risk contracts that received reinsurance accounting or other preferred accounting treatment were later found to have transferred insufficient insurance risk to qualify for such treatment.

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